Current Economic Problems

CURRENT
ECONOMIC PROBLEMS

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THIRD EDITION

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by

Paul F. Gemmill, Ph.D.
Professor of Economics
University of Pennsylvania

and

Ralph H. Blodgett, Ph.D.
Professor of Economics
University of Illinois

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Current Economic Problems, as the title suggests, is an exposition of urgent economic problems that today confront the people of the world, and more particularly of the United States. It does not contain elaborately detailed statements of the development of these problems, nor are its pages crammed with statistics. While *history* and *facts* have a place in the study of economic problems, we believe they may easily be over-emphasized. Material of this kind has been introduced into the present volume only when it has seemed likely to aid in the *interpretation* of the problem under discussion. We feel that the important thing, in the case of each problem, is for the reader to know *what the problem is* and *what can be done about it.* The emphasis, then, is upon *analysis* and *evaluation,* rather than upon history and facts.

The book is distinctly a joint product. The task of actual writing was divided about evenly between us, and the senior author served as general editor. Our almost daily association over a period of ten years has given us abundant opportunity to iron out difficulties in terminology and reconcile differences of opinion, and has resulted, we believe, in bringing to *Current Economic Problems* a higher degree of *unity* than is ordinarily found in collaborations.

PAUL F. GEMMILL
RALPH H. BLODGETT

February, 1939

Preface to the Third Edition

This new edition of *Current Economic Problems* brings up to date the study of the economic maladjustments that were dealt with in the first two editions of this work, and gives special attention to war-time and post-war developments. The willingness of the publisher to reset the entire book has made it possible for us to give the text a thorough overhauling, and to include all minor as well as major changes that seemed desirable.

P. F. G.
R. H. B.

January, 1947

A BACKGROUND FOR THE STUDY OF ECONOMIC PROBLEMS

1. The Study of Economic Problems

The rise of the factory system, which introduced the use of large quantities of capital and the application of mechanical power to industrial processes, dates from the last quarter of the eighteenth century. "Other times, other customs," runs the proverb; and there can be no question that the "other times" in which we live today have brought with them decidedly "other customs," so far as economic life is concerned. Among other things, we have moved from a simple economic system into one that is most complex. The hand process has become the machine process, specialization by trade has given way in many instances to specialization by task, and the independent artisan who was once his own master is now a factory worker who is directed by a foreman, who in turn takes orders from a superintendent, who is responsible to a general manager, who is under the control of the board of directors and ultimately of a group of stockholders.

In economic life, as in other forms of human activity, changes that are made in the name of progress are often opposed by those who see in them a threat to their individual self-interest or to social welfare. The introduction of the power loom was effected only by beating down the objections, and in some cases the persons, of the hand weavers. The movement for free public schools had to overcome the opposition of owners of private schools who feared competition, and of taxpayers who disliked the increased levies necessitated by this social project. Anti-trust legislation has been championed by those who regard great combinations as a menace to the public good, and condemned by the champions of *laissez faire* and those who stand to benefit through monopoly control.

Changes in the economic world almost inevitably bring gains to some persons and losses to others, and consequently give rise

to economic problems. Since changes are continually occurring in a growing economic society, we are faced, year by year, with economic problems old and new—the old ones returning from temporary retirement to plague us, and the new arising out of fresh combinations of circumstances and challenging us to solve them if we can.

The Nature of Economic Problems. The existence of an economic problem means the presence of conditions in which the interests of some persons are being affected adversely. Since, in the study of economics, we look at matters from the social point of view, we may define an economic problem as *a maladjustment in economic conditions which results in loss to a considerable number of members of society.* No one who is informed on events of the day will question that such maladjustments do exist, and that they often lead to serious consequences. Violent fluctuations in the general level of prices, involuntary idleness on the part of some millions of workers, the stoppage of streetcar or train service by reason of a strike, the wasteful exploitation of coal and petroleum resources—these are a few of the major maladjustments of twentieth-century economic life that still await solution. They are taken from the long list of economic problems that confront us, and that bring to some members of society a sense of economic injustice and insecurity as well as standards of living lower than we should have if we disposed effectively of these maladjustments.

We have referred to the fact that, as students of economics, we examine conditions from the social rather than the individual point of view. We are interested in studying our economic institutions and business practices with the primary purpose of determining their effects upon society, and not upon isolated individuals only. Because economists adopt the social outlook, the study of economics is rightly classified as a social science. Indeed, we shall find that many of the problems that we examine are not *economic* problems pure and simple, but are related, in greater or lesser degree, to other social sciences as well. The problem of population, for example, is an economic problem, by reason of the relationship between population and wages; but it is also a problem in sociology, because of the relationship of population to the family, which is a social institution; and, finally, it is a political problem as well. through its connection with immigration. Few persons would dispute the statement that the tariff problem is both economic and

political, or that the problem of poverty may be said to fall within the province of economics, sociology, and political science, and not within the scope of only one of these fields.

Interrelationships of Social Problems. Since many of the problems of today are related to several fields of social science, it is sometimes possible to find a remedy for one phase of a given problem while other phases go unsolved. The Negro problem, for example, was solved in part by the freeing of the American slaves. But the abolition of the institution of slavery in this country did not solve the Negro problem in its entirety. Its economic phase was not remedied by this step. Indeed, freedom increased rather than decreased the economic difficulties of the Negro; and so serious is the present economic maladjustment of the American Negro that large numbers of our colored population are living under conditions which cannot, with any degree of reasonableness, be considered an "American standard of living." The emancipation of the slaves introduced, moreover, a brand new political phase of the Negro problem; for with freedom came the question of the political status of this large group of citizens, which now comprises about 15 per cent of our total population. This, then, is another phase of the Negro problem that remains unsolved.

Yet another illustration of the complications of social problems is to be found in the question of prohibition. Whatever one may think of the wisdom or unwisdom of attempting to discourage the use of alcoholic beverages through legislative measures, one cannot fail to see that the passage of the 18th Amendment and the Volstead Act, some years ago, gave rise to new social problems. The sudden closing of breweries and distilleries rendered practically worthless millions of dollars' worth of highly specialized capital, threw out of employment thousands of workers whose industrial lives had been spent in the liquor business, and destroyed the market for an appreciable part of certain grain crops. The political aspects of the problem of prohibition are evident to everyone who followed the presidential campaign of 1928, and the local elections of later years. Other serious problems that arose, in part at least, from our attempts to solve the liquor problem by legislation, were the loss of health and even life resulting from drinking poisonous "bootleg" liquors, and the increased strength (in both numbers and influence) of the metropolitan gangs that prospered from the illicit manufacture and sale of alcoholic beverages. We

are not here considering the merits or demerits of either Negro slavery or prohibition, but merely indicating that out of an attempt to remedy a specific social problem, maladjustments of other kinds often arise.

The Importance of Studying Economic Problems

It seems most unlikely that anyone who has kept track of current events during the past three or four decades could doubt that economic considerations have been playing a leading rôle in local, national, and world affairs, or that they are destined to occupy center stage for many years to come. Are there wars and rumors of war? Then they are as likely as not to have an economic basis, and are certain in most instances to have far-reaching economic consequences. And if, happily, the paths we follow are the paths of peace, even then we cannot escape the necessity of dealing with economic problems, for business depression, gross economic inequality, financial inflation and deflation, and many other types of economic maladjustment thrust themselves upon us from time to time. In these days of economic interdependence, he is indeed a *rara avis* whose lot is not affected by economic changes. We should be able, then, to assume an interest in economic problems, on the part of all members of society. It will be worth our while, however, to indicate briefly several specific reasons for undertaking the study of this subject.

Economic Problems and the Business Man. The interest of the business man in economic problems is very often based upon self-interest. When changes threaten, which would interfere with the enterpriser in securing the land, labor, or capital needed in his business, with converting raw materials into finished products, with marketing his goods, or with retaining for himself whatever income he is able to make his business yield him, the business man is faced with the problem of combating these changes or adjusting himself to them once they have come upon him. That such changes do come from time to time will be clear to all who read the daily newspapers. We need not go far back in history to find instances of governmental restrictions being placed upon the supply of certain kinds of capital, such as nitrates and raw rubber; of manufacturers being required by law to pay compensation to injured workers; of "interference" in marketing, with Better Business Bureaus and similar organizations insisting that goods

must measure up to the claims made for them; and of large percentages of profits and managerial wages being taken by the government, through excess profits levies and income taxes. There can be no question that business men need to know the "ins and outs" of economic problems that relate to their particular enterprises.

It was a problem of this kind that confronted the United States Steel Corporation in 1921, when the United States first enacted legislation definitely restricting the volume of immigration to this country. The late Judge Gary, who was then president of the Steel Corporation, announced publicly and in no uncertain terms that the erection of immigration barriers would interfere greatly with the operation of his company by excluding from admission to the United States large numbers of southern and southeastern Europeans, upon whom the steel companies of America depended for their supply of unskilled labor. According to Mr. Gary, a reduction in the number of laborers available for employment in the steel works of the country would inevitably result in higher wages, and, as a consequence, in higher prices for steel. A further possibility, though it was not emphasized by Mr. Gary, was that of experiencing smaller profits if the conditions of demand for steel should not make it feasible to increase the selling price of this product. In any case, there can be no doubt that Mr. Gary was genuinely interested in the problem of immigration.

Similarly, a prominent manufacturer of woolen goods was much interested in an economic problem during the presidential campaign of 1928, and, indeed, was fearful that, through the election of a Democratic President and a Democratic House and Senate, he would suffer serious economic loss. He contended that the success of his business hinged upon the continuance of a high tariff on manufactured woolen goods, and that the Democrats, if they got into power, might indulge in so violent a downward revision of tariff rates that he would be unable to manufacture his product in competition with the foreign makers of similar goods. As matters developed, his fears proved to be without foundation; for the Democratic presidential candidate, before the close of the campaign, not only promised publicly not to tinker with the tariff in the event of his election, but also secured similar pledges from the Democratic members of Congress. The fact remains, however, that this manufacturer was but one among thousands of enterprisers

whose attention has been directed to specific economic problems because these problems have threatened the successful operation of their respective businesses.

Of a different sort was the interest once manifested by a Philadelphia merchant in the problem of low wages. Though not much given to reading about social conditions, he one day learned from a magazine article that the minimum income on which a family of average size could live in "health and decency" in Philadelphia was $2000. Upon consulting his payroll, he found that some of his own employees, who were the sole breadwinners of families even larger than the hypothetical family of four persons, were drawing annual wages as low as $1300. Genuinely concerned over the discrepancy between the wages he was paying and the minimum estimates of budgeteers, he sought out specialists in the field of industrial economics in the hope of discovering a remedy for what he considered a very undesirable situation. Unfortunately, there appeared to be no satisfactory solution of this particular problem in an economic order based upon competition. The incident shows, nevertheless, that an understanding of economic problems is of significance to socially-minded business men —business men whose interest in economic processes is not limited to the possibility of extracting large profits from the operation of their enterprises.

Economic Problems and Intelligent Citizenship. But the need for a working knowledge of economic problems is by no means confined to the business man. In these days of large-scale collective action, the average citizen is called upon, time and again, to vote, directly or indirectly, on matters of the greatest economic significance.

The end of World War II posed for the people of the United States a whole series of important economic problems. Should this country yield to the appeal of Great Britain for a loan of some four billion dollars to be used in the rehabilitation of her run-down industrial plant? If so, should we exact an interest payment, or grant the loan free of interest? Or should we, perhaps, make the British an outright gift, rather than a loan, because of the widespread devastation of her physical assets suffered in the course of a war in which Britain and the United States fought in a common cause?

Another post-war problem of the utmost significance was the

retention or abandonment of the price controls that had been applied with considerable success for several years prior to the termination of fighting. The National Association of Manufacturers and other business organizations urged a return to the "free market," in which prices would presumably be held in check by the interplay of supply and demand. But large numbers of American citizens, most of our academic economists, and the federal administration under the leadership of President Truman, insisted that the withdrawal of price controls, if it took place before a reconverted industrial system had had an opportunity to replenish depleted stocks of goods, would inevitably lead to disastrous inflation and consequent economic chaos.

If it should be said that these are exceptional cases, the point may be conceded cheerfully, but with the comment that we are being called upon continually to elect men to represent us in deciding important economic matters, and that we have some responsibility in seeing to it that we are properly represented. We have the privilege of advising our lawmakers from time to time, and of repudiating them when they come up for reelection if they have failed to do our bidding. But this privilege, if it is to be exercised, carries with it the obligation to offer sound advice or none at all, and the ability to advise intelligently rests upon an understanding of the issues under consideration. Shall we change the tariff, and if so, shall we have an upward or downward revision? Shall we nationalize the railroads, as many nations have done, or leave them in the hands of private enterprisers? Shall we have socialized medicine for our citizens, or continue to pay for medical service and hospitalization on a purely individual basis? Shall we yield to the ever-present demand for a lowering of federal taxes, or hold fast to high rates of taxation and use part of the revenue to reduce our enormous national debt? These are samples of scores of economic problems of the present day that demand attention. We cannot afford to entrust their solution to lobbyists and professional politicians. Maladjustments that affect the public welfare, as most economic problems do, are worthy of the close study of every person who takes his citizenship seriously.

Economic Problems and General Culture. But even to those who do not enthuse over the exercise of the franchise in the interests of economic reform, the study of economic problems may have some appeal as a matter of general culture. If culture is, as Webster says,

"the training, disciplining, or refining of the moral and intellectual nature," it would seem that an understanding of the causes of economic maladjustments and their effects upon the welfare of society might well be considered a desirable part of one's cultural equipment. No one who has attempted seriously to analyze any of the major problems of economics today, will question that such analysis does contribute to the training and disciplining of one's intellectual faculties; and it can scarcely be denied that a sincere attempt to set right the maladjustments that so mightily influence human welfare may do something to develop and "refine" one's moral nature.

Indeed, economic discourse has become so much a part of our everyday life that a man takes something of a chance if he leaves home without being prepared to hold his own in economic argument. Not only in the college classroom, but in the restaurant, on the train, or at the club, one is expected to know the best way to settle labor disputes and to have ready a plan for the expansion of world trade! We do not suggest that a study of general economic problems will enable one to attain a perfect grade in these encounters, but it should certainly help to improve one's score. The professional economist himself will sometimes admit that he does not have a sure remedy for every economic ill! But it is possible, in most instances, to get an insight into the nature of a given economic problem and to learn something of the circumstances that have brought about the maladjustment; and it is often feasible to choose from among the proposed solutions of the problem the particular one which seems most likely to relieve the situation, and to know why it appears to be superior to the others.

It would be unreasonable, of course, to expect all of us to be as well versed in problems of an economic nature as the specialists. There is no need, however, for anyone to make the mistake of the business man who concluded that all organized workers were grafters because he had learned of crookedness in a particular union in his city, or to accept uncritically, as some persons have accepted, the editorial dictum that the Russian experiment must inevitably fail because it is not in accord with the economic procedure that has made America great. Not only does the study of economic problems provide one with a fund of interesting, important, current information, but it impresses upon one the complexity of certain problems which on the surface may appear

simple, and enables one to sift the wheat from the vast amount of economic chaff that nowadays finds its way into our newspapers and magazines. A little learning is proverbially a dangerous thing, but a moderate amount of time given to the critical analysis of economic problems will help to put one on guard against the acceptance of the snap judgments that are offered so freely in conversation and print.

The Feasibility of Altering Economic Conditions

In the opening paragraph of an article in which he discussed the possibilities of world peace, Albert Einstein, the noted scientist, once wrote: "Let me begin by stating this political conviction: that the State exists for man, and not man for the State. The same may be said of economic institutions. This is an old principle, laid down by those who rated human personality as the highest of human values. I should hesitate to restate it if it were not constantly in danger of being forgotten, especially in this era of organization and standardization." Choosing from this quotation the part that relates to our present inquiry, we endorse most heartily Professor Einstein's suggestion that economic institutions exist for man, and not man for economic institutions. Economic institutions, like other social institutions, have grown up because they have seemed to serve a useful purpose; and when they have outlived their usefulness they can be, and should be, either modified or eliminated.

Man's Control of Economic Conditions. And yet, there are a good many persons who appear to believe that economic forces are wholly beyond the control of man, and that economic institutions are sacred and must not be tampered with. When workers go on strike, either to force a wage increase or to prevent a wage cut, we are quite likely to find editorial writers advancing the theory that wages are determined by conditions of supply and demand, that neither employers nor employees can do anything about it, and that it is consequently foolish of the workers to call a strike in an attempt to control wages. Now we may accept the statement that the conditions of supply and demand determine wages, and even agree that this will always be the case in a competitive society, without conceding that particular social groups are "in the fell clutch of circumstance" and must resign themselves to whatever wages—high or low—the gods may send. The

truth of the matter is that wages will rise whenever the demand for labor is increased without increasing the supply, or the supply of labor decreased without decreasing the demand. In Chapter 4 we shall note in some detail a proposal for raising the wages of those in the low-income groups by controlling the size of the population and hence the supply of labor. As for economic institutions, there is every reason to believe that they can and will be changed, whenever society deems a change desirable and takes the trouble to bring it about. A comparison of economic conditions today with those of a century ago reveals the fact that the institution of free enterprise, for example, which is thought by many to be a prime essential of our economic society, has undergone extensive modifications in this relatively short period.

Some Attitudes Toward Economic Change. It is true, however, that there are many obstacles that must be overcome before any important economic change can be effected. One of the most persistent is the attitude adopted by a surprisingly large number of persons, to the effect that there is no hope of bringing about reforms that involve changes in human nature. This was obviously the view of the member of the Daughters of the American Revolution, who is quoted as saying: "Can any woman pray for peace more than I? . . . But what can we do if it is ordained otherwise? Human nature can never change. Wars can never be eliminated. We must sacrifice and be ennobled. We must give and be rewarded in the hereafter." Obviously, if society in general were to agree with this apostle of despair, there would be an end to all attempts to improve world conditions. Fortunately for social progress, there are many who are convinced that we are not so helpless as we are here pictured. So far as the bogey of "human nature" is concerned, it really matters but little, after all, whether human nature does or does not change, so long as its outward manifestations are brought into conformity with socially desirable ends. It may be questioned that human nature has changed sufficiently, in many millenniums, to affect greatly man's desire to acquire commodities and services; but there can be little doubt that the manifestations of the acquisitive instinct are less likely today than in the Stone Age to take the form of physical violence. To most persons this change would seem to be a gain; and the change, it may be noted, is one that is closely related to the development of the economic institution of private property.

A second notion that has done much to interfere with economic advancement is the curious idea that any sudden or far-reaching change is, for some reason or other, immoral or irreligious. The attitude is illustrated by a pronouncement of the school board of Lancaster, Ohio, in 1828, which read as follows: "Sir: You are welcome to use the school house to debate all proper questions in, but such things as railroads and telegraphs are impossibilities and rank infidelity. There is nothing in the Word of God about them. If God had designed that his intelligent creatures should travel at the frightful speed of fifteen miles an hour by steam He would clearly have foretold it in his holy prophets. It is a device of Satan to lead immortal souls down to Hell." Read more than a hundred years after it was penned, this letter sounds more than slightly ridiculous, but probably not more ridiculous than certain present-day economic views will sound when examined in the light of the twenty-first century. We may feel pretty certain that the wise men of a hundred years hence will get many a chuckle from reading about twentieth-century opposition to family limitation, practiced in the interests of high standards of living; opposition to the control of credit, designed to stabilize the general level of prices; and opposition to the control of natural resources, advocated to preserve a supply of raw materials for the use of future generations. We have not as yet, we may frankly admit, got over the notion that there is something immoral about interference with economic *laissez faire*.

Yet another attitude that blocks economic progress is illustrated by the story of a tramp, as related by Lady Asquith in her autobiography. Her account is as follows:

> Another day, when it came on to rain, I saw a tramp crouching under the dyke, holding an umbrella over his head and eating his lunch. I went and sat down beside him and we fell into desultory conversation. He had a grand, wild face, and I felt some curiosity about him; but he was taciturn and all he told me was that he was walking to the Gordon Arms, on his way to St. Mary's Loch. I asked him every sort of question—as to where he had come from, where he was going, and what he wanted to do—but he refused to gratify my curiosity, so I gave him one of my cigarettes and a light and we sat peacefully smoking together in silence. When the rain cleared, I turned to him and said: "You seem to walk all day and get nowhere; when you wake up in the morning, how do you shape your course?"
>
> To which he answered: "I always turn my back to the wind."

In things economic, as in so many other matters, a large number of the members of society appear to be content to turn their backs to the wind or to drift with the stream—in other words, to allow the force of inertia to prevent their doing anything about the economic conditions which they professedly regard as deplorable, but in which they are not sufficiently interested to enter actively into a search for a remedy and a fight to bring about its adoption.

The Plaint of the Tired Reformer. Closely akin to the attitudes that we have described—at least in its effects in retarding economic change—is that of the tired reformer. Mr. Bruce Barton is a specimen of this type, if we may accept his own statement as it appeared some years ago in a popular magazine. "The three reasons why I personally have retired from the reforming business," said Mr. Barton, "are: First, because I am getting older. Second, because I think that if every man takes care of his own life, and his own family the total result is going to be pretty satisfactory. . . . Third, the forces that are working to make the world better are so powerful and are making such satisfactory progress that they do not need any great amount of artificial stimulation."

The relationship between Mr. Barton and Lady Asquith's tramp should be apparent. Both are fairly well satisfied with conditions as they are, or at any rate both have decided to turn their backs to the wind. There seems to be, in a case of this kind, more excuse for the tramp than for the tired reformer. Certainly the latter cannot plead ignorance of the situation as a defense of his inactivity; and his suggestion that "satisfactory progress" is being made can scarcely be credited unless the cause he formerly championed is getting along quite as well without his help as with it. However this may be, the defection of those who have been associated with economic reform, and their lapse into indifference, are assuredly responsible in some degree for delaying the changes that must be made before certain economic maladjustments will have been remedied.

Specific Instances of Economic Change. We return now to the main issue of this section of the present chapter, that is, to the feasibility of altering economic conditions. Probably the best evidence that economic conditions *can* be changed is the indisputable fact that economic changes have been wrought in response to demands that certain maladjustments be remedied. Economic inse-

curity has been relieved to some extent by social insurance of various forms; the American problem of immigration has led to the erection of barriers against the influx of foreigners; the inelasticity and insecurity that long characterized our commercial banking system have been remedied, in part at least, by the Federal Reserve Act and later legislation, our tariff rates have been modified, time and again, to bring them into line with the views of the administration in power. These and similar economic changes that are described in this and other works on the subject are proof positive that society is not powerless in the face of economic maladjustments.

The Method of Approach

Economic Principles and Economic Problems. Many economists find it convenient to divide their subject into two general groups of items, the first consisting of economic principles and the second of economic problems. To be sure, there is no clean-cut line of demarcation between the two in actual economic life, but there is something to be said for separating them for purposes of study.[1] The subject of *economic principles* relates to an examination of the economic system as it is, with the purpose of discovering the fundamental principles upon which it is based and in accordance with which it *tends* to operate. We refer here to such economic "laws" as the Law of Diminishing Returns, the Law of Supply and Demand, and the Law of Comparative Advantage. Economic principles are comparable to the laws of physics and chemistry, in that they are generalizations that are applicable only under certain stated conditions, and, further, in their freedom from any implication that the system which they describe is a socially desirable system. The purpose of economic principles, then, is merely to describe accurately the workings of our economic system, granted certain stipulated conditions. One might be a thorough scholar in the field of economic theory, and make great contributions to our understanding of fundamental economic processes, with never an expression as to the merits or defects of the system—just as a student of anatomy might spend a lifetime studying the human body, aiding physicians and surgeons greatly with his discoveries, and yet saying nothing

[1] In many of the standard college textbooks on economics, both *principles* and *problems* are treated in a single work. See, for example, Paul F. Gemmill and Ralph H. Blodgett, *Economics: Principles and Problems,* New York, Harper & Brothers, rev. ed., 1942, vols. 1 and 2.

about whether he thought the "human machine" a fine piece of mechanism or a badly bungled bit of creation.

There is no reason, of course, for denying the student of economics the privilege of making appraisals, but this is a privilege that should be exercised in the field of *economic problems.* Economic principles describe the workings of the system, while economic problems deal with the maladjustments of our economic life. The student of economic problems looks about, sees conditions that strike him as being socially undesirable, and proceeds to search for a remedy. This is precisely the sort of thing that has been done in the case of the economic problems that were chosen for treatment in the present volume. In most instances, the authors, in planning and writing a given chapter, have asked themselves such questions as these:

1. What are the indications that a problem exists; that is, what are the symptoms?
2. What are the causes of the maladjustments?
3. What can be done about it?

It will be obvious to the careful reader that the collection, selection, and presentation of the material essential to the understanding of an economic problem inevitably involve a very considerable expenditure of time and effort. It is not our purpose, in this book, to discuss the technique employed in "working up" an economic problem, but it is believed that a critical examination of the problems here presented will give some idea of the various methods of attack that are available. In general, having made a diagnosis of the situation, we may well follow the advice of Professor John Dewey, to "decide upon what we want socially, what sort of social consequences we wish to occur, and then use whatever means we possess to effect these intended changes."

The Use of Theory in Solving Problems. One of the sad facts about our reformers of economic conditions, is that they often set forth upon their careers of reform, and undertake to solve economic problems, without understanding the principles with which the problems or the proposed solutions are tied up. As a consequence of this limited knowledge of economic theory, well-intentioned but misguided individuals regale us from time to time with economic proposals that are highly fantastic. Every business depression yields its crop of plans for the governmental printing of large

quantities of paper money to be used in relieving the "money shortage." Repeated exposure of the dangers of monetary inflation has done little or nothing to discourage these champions of "cheap money." And when unemployment descends upon us, we are often informed that the *only* way to provide steady work for all is to cut down the length of the working day, no thought, apparently, having been given to the possibility of working full time and thus raising our standards of living.

It is into errors such as these that economic reformers are likely to fall if they approach their task without a knowledge of economic principles. *Current Economic Problems* was written with the thought that it would ordinarily be read by those who understand something of economic theory. We know of no way to find sound solutions for economic problems without recourse to economic principles. We believe, therefore, that the present volume will prove most helpful when its use is preceded by training in theory; that in the usual one-year college course in introductory economics, for example, it can best be used as a text for the *second* term, following a *first* term devoted to the study of theoretical economics. Nevertheless, an attempt has been made here, in the case of each problem, either to explain briefly the economic principles that apply to its analysis and solution, or to refer the reader to particular theories that are treated at some length in all the standard textbooks on economic principles.

A Plea for Objectivity. We must not close this introductory chapter without urging the reader to adopt, so far as he finds it possible to do so, what is often called the "scientific attitude," in his study of economic problems. This does not mean that he need hold himself coldly aloof and remain untouched by the human suffering that accompanies so many of our economic maladjustments, but rather that he should demand factual evidence at every stage of an analysis. He should feel free to reject any and all statements that are presented without the support of either inductive data, or a logically reasoned deduction based upon acceptable premises. In a word, he should be "from Missouri," maintaining a receptive but skeptical attitude, weighing critically every scrap of evidence as it makes its appearance, and finally rendering a judicial decision that is free from preconceptions and personal bias. If this procedure is followed, the reader may rest assured that his study of these selected economic problems will not be fruitless,

no matter how promptly he forgets the details and his verdict as to the soundness or unsoundness of the solutions that are proposed.

We are not suggesting that the task outlined above is an easy one. On the contrary, it is most difficult to divorce one's thinking from one's personal background and achieve strict objectivity, when considering matters that are as highly controversial and as important personally as are most economic problems. A young man's attitude toward unionism is likely to be colored by the fact that his father is a manufacturer and has had his authority challenged by union officials; his attitude toward a high inheritance tax may be influenced by the knowledge that he will some day inherit a fortune—or, on the other hand, by the certainty that he will inherit nothing, so that even a hundred per cent tax of this kind would mean no personal loss; his impatience with widespread unemployment may be tempered by the fact that he has himself never known real hunger, and by the impression, mistaken but all too prevalent, that it is only the shiftless and lazy who cannot find work.

We repeat, therefore, that the achievement of objectivity, or an "open mind," is not easy, but it is a goal that is well worth striving for. There is great need today, in the world of affairs, for disinterested investigators—for men and women who can be trusted to examine problems of social import in various fields of human endeavor, and to make analyses and propose solutions that are not tinged with self-interest. We ask, therefore, that the reader approach this study of economic problems in the spirit of impartial inquiry, with a firm determination to find out what there is of truth or error in our treatment of some of the outstanding issues of present-day economic life. We feel confident that this is the spirit that must be adopted if the study is to yield the greatest possible return of pleasure and profit.

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1. In economic life, changes that are made in the name of economic progress are often opposed by some persons. Why?
2. Discuss briefly any social problems that appear to you to have arisen out of the following developments:
   a. The popularity of motor transportation.
   b. The development of radio broadcasting.
   c. The growth of the motion picture industry.
3. What is meant by the term "social science"?

4. "Out of an attempt to remedy a specific social problem, maladjustments of other kinds often arise." Illustrate.
5. "We should be able to assume an interest in economic problems, on the part of all members of society." Discuss this statement, under the headings "business success," "intelligent citizenship," and "general culture."
6. The late Andrew M. Mellon is reported to have said, in an interview: "It is as impossible to change the present distribution of wealth as it is to cause the earth to stop revolving." Compare this statement with the paragraph of Chapter 1 entitled "Man's Control of Economic Conditions."
7. There are a good many members of society who apparently feel that "there is something immoral about interference with economic *laissez faire*." Should not these persons, to be consistent, object to interference with mad dogs, smallpox germs, and weeds in gardens; that is, should we not interfere either always, or not at all, with conditions that are socially objectionable?
8. Indicate the difference between *economic principles* and *economic problems*.
9. In undertaking to make a study of a specific economic problem, what questions would you expect, by the time your study was completed, to have answered?
10. What is the meaning of the "scientific attitude," and why is it important in the investigation of economic problems?

2. *The Operation of a Capitalistic Economy*

*Economic problems, as the preceding chapter has indicated, in-*volve maladjustments in the operation of our economic system. While our primary interest in the present volume is in such maladjustments, the discussion of economic problems will be more meaningful if we pause briefly to review the manner in which a capitalistic system is supposed to operate, before turning to the departures from such operation. A capitalistic economy is characterized by such institutions as private property, free enterprise, economic self-interest, and competition; but these institutions merely provide the framework within which economic decisions are made and economic activity is carried on. The actual making and carrying out of economic decisions depends upon still another institution.

Every economic system is faced with the basic problem of satisfying great and growing human wants by utilizing certain scarce means of production which have alternative uses. In this situation, some way must be found to determine (1) the apportionment of existing limited quantities of consumable goods among the members of society; (2) the kinds and quantities of economic goods to be produced; (3) the allocation of the limited quantities of the productive agents among the various industries and fields of production; and (4) the total quantities of reproducible agents of production to be made available in the long run. While these decisions may be made in other ways in other types of economic systems, under capitalism they are usually made by enterprisers *on the basis of price relationships*. The part played by the price system in reaching these fundamental decisions is so important that many economists consider the money and price system the most significant single institution of a capitalistic economic order.

The Functions of the Price System

The Apportionment of Existing Economic Goods. We shall now examine in some detail the functions performed in our economic order on the basis of the price system and price relationships. In the first place, prices determine who shall have access to existing stocks of economic goods, and how these goods shall be apportioned. Sometimes the problem is one of restricting purchases of a good to a quantity which can be satisfied by the existing limited stock. In other cases, the difficulty is to find enough purchasers to take the large existing stock of a good from the market. If, for example, the available quantity of butter is unusually small, a rising price induces some people to give up this commodity altogether, and others to restrict their purchases to smaller quantities than usual. In this way the market demand for butter is kept from outrunning the market supply. And if an unusually large quantity of (say) strawberries is available on the market, a falling price attracts new customers and induces others to buy larger amounts than usual, so that market supply does not outrun market demand.

This need for a device to apportion existing stocks of economic goods among consumers is a characteristic of our modern complicated economic system. When each individual or family was economically self-sufficient, producing a considerable variety of goods on a small scale by fairly direct methods, the same persons were both producers and consumers and the problem of apportionment did not exist or was relatively unimportant. Under modern conditions, however, one set of individuals specializes in producing a certain article, turning it out in large quantities by indirect methods, and a second set of individuals—largely or entirely separate from the first—consumes the article. Under such conditions, the problem of adjusting consumers' demands to the existing quantities of goods becomes of the utmost significance.

The leading alternative to the apportionment of consumable economic goods through price adjustments is apportionment by means of quantity adjustments. That is, in a given economic system, the government or an agency of the government may keep the price of a good stable and low, regardless of whether the quantity available is large or small, and may increase or decrease the quantity each individual or family is allowed to purchase in a week or some other period of time. Rationing of this kind has the

tually decrease their capacity for production. The industry is unlikely to attract new agents of production, and on the contrary probably loses some of the agents formerly employed. The final result is that output decreases until the quantity produced finds buyers at a price that is reasonably satisfactory to the producers. Thus the prices of finished goods, and the prices of productive agents used in making them, aid enterprisers in deciding what kinds and quantities of economic goods to produce.

Production Control in Wartime. Theoretically, the expansion and contraction of various industries, and the conversion and reconversion of productive facilities, could be allowed to depend upon cost-price relationships even in wartime. For example, the government might undertake to pay such high and profitable prices for airplanes that existing airplane factories would run at full capacity, automobile producers would voluntarily curtail or stop the production of automobiles and convert their facilities to the production of airplanes, and new firms would be induced to enter the field of airplane production. Similarly, the industries engaged in war production might attract the necessary workers by paying wages much higher than the workers could obtain in industries producing civilian goods, and so on.

However, in practice the government is likely in wartime to resort to direct control over production, and over the extension and conversion of productive facilities. The reason is not that wartime problems are unusual in *nature*, but rather that they are unusual in *scope* and *urgency*. In peacetime, the conversion and extension of productive facilities occur gradually, and only a small number of industries may be seriously affected at any one time. In wartime, the conversion and extension of productive facilities are needed immediately, and most, if not all, industries are affected to some extent.

Moreover, if the banks are creating a considerable part of the funds necessary to finance the government's war expenditures (by buying government bonds and paying for them by creating demand deposits for the government), reliance on price relationships to induce the extension and conversion of productive facilities may be ineffective and costly. That is, if the government spends much more for war than it takes out of the current incomes of the people through taxes and direct sales of bonds, the willingness and ability of the government to pay high prices for airplanes or other war

goods may be offset to a considerable extent by the willingness and ability of private individuals to pay high prices for automobiles or other civilian goods. In such a situation, the extension and conversion of productive facilities may not go forward as desired, and the money cost of the war may be greatly increased as prices rise because of the competitive bidding of government and people for war goods and civilian goods, respectively. When agents of production are fully employed, competitive bidding for their services may result in serious inflation. Hence, in wartime a government is likely to control prices directly and to regulate production through official boards or other agencies.

Soon after the United States entered World War II, the task of speeding and guiding the output of necessary goods was assigned to the War Production Board, which was created by two Executive Orders issued by the President of the United States. The War Production Board was authorized (1) to exercise general direction over the war procurement and production program, and (2) to determine the policies, plans, procedures, and methods of the several federal departments, establishments, and agencies with respect to war procurement and production, including purchasing, specifications, and construction, and including conversion, requisitioning, plant expansion, and the financing thereof; and to issue such directions with respect thereto as might be deemed necessary or appropriate. The Board established a number of regional offices, located in large cities from coast to coast, to facilitate the handling of local and regional problems.

The powers of the Board were, of course, very great. It could order industries producing civilian goods to curtail production or even stop operating altogether, and it could permit them to resume operation when needs for war production moderated to some extent. It could take almost any necessary steps to insure the adequate production of essential war goods. Conversion and extension of plant facilities could be undertaken only with the approval of the Board, and the Board controlled the allocation of vital materials and capital goods among firms and industries. With the coming of peace, its regulations and controls were rapidly relaxed, for the existence and functioning of such an agency in peacetime would be quite foreign to the nature of a capitalistic economic system.[2]

[2] The governmental price control which accompanied the control of production during World War II is discussed in chap. 11.

The Apportionment of Productive Agents. As the explanation of the control of production by means of cost-price relationships suggests, the price system does more than control the output of finished goods. The prices which producers are willing to pay for the agents of production furnish the basis for distributing existing quantities of the scarce agents among various industries under capitalism. Consider land, for example. Owners of land are likely to consider carefully the several uses to which their land might be put and the rents that would be paid by the various enterprisers who are willing to lease it. When landowners entrust their land to the enterprisers who offer the most favorable terms, they are apportioning the existing quantity of this scarce agent of production among the various industries, and thus are encouraging the production of certain economic goods rather than others.

The available quantity of capital is distributed in a similar fashion. Capital results from saving, and savings are dependent upon the existence of incomes larger than are required for current consumption. Savings are sometimes invested directly by the savers themselves, but more often that responsibility is transferred to other persons or institutions. In any case, those who have savings usually seek investments which will bring the highest rates of return, after making allowance for variations in risk as between industries. By the act of turning savings over to certain industries, the investors make it possible for these, rather than others, to acquire needed supplies of capital goods. In this way, the quantity of capital available for production is apportioned among the various industries, and certain types of production are encouraged while others are discouraged.

Even labor, the human agent in production, is distributed among the various industries of our economy largely on the basis of the relative prices offered for it. While a high or low wage is not the only influence that leads workers to prefer one occupation to another, differential earnings remain the most important single factor in bringing about these decisions. Other things being equal, workers are attracted by high and repelled by low wages. The volume of labor in a declining industry falls off as the workers are asked to accept lower wages than formerly, or as it becomes evident that the children of these workers will be poorly paid if they follow their fathers' occupation. But a new and expanding industry can attract a considerable part of the existing labor supply because it is able to

pay higher wages than workers could command in industries that are less favorably situated.

The competitive bids of enterprisers for the agents of production tend to set high prices on the relatively scarce agents and low prices on the more plentiful agents, encouraging a smaller use of the former and the fuller employment of the latter. A low price for a relatively scarce agent would lead to its waste in trivial uses, but a high price reserves it for more important employments. A high price for a relatively plentiful agent would cause enterprisers to economize in its use, and many units of the agent would remain idle; but a sufficiently low price tends to put all units of the agent to work, in the long run.

The Apportionment of Productive Agents in Wartime. In wartime, the government is likely to resort to direct control over the apportionment of productive agents among industries and businesses, in order to achieve the exact allocation deemed most appropriate for the effective prosecution of the war and to prevent an undue bidding up of the prices of the agents after full employment has been reached. For example, the allocation of vital materials among firms and industries in the United States during World War II was made on the basis of the so-called Controlled Materials Plan. Prime contractors all over the country were required to assemble bills of materials needed, specifying kinds, quantities, and the times at which needed. These bills of materials were submitted to seven claimant agencies: Army, Navy, Maritime Commission, Aircraft Scheduling Unit, Board of Economic Warfare, Lend-Lease Administration, and Office of Civilian Supply.

The claimant agencies combined the bills of materials sent in by their contractors and submitted them to the War Production Board, which matched total requirements of the claimant agencies with available supplies of materials, making allowances to these various agencies according to their importance. The claimant agencies followed their own preferences in distributing their allotments to the prime contractors, who in turn rationed the materials to subcontractors. The allotments to contractors amounted to "certified checks" for specific quantities of materials in specific periods of time. Finally, the War Production Board had to inform the producers of the materials what kinds and amounts of materials to produce in order to meet the allocated demand in each period. Such a method of apportioning scarce productive agents among industries

and businesses differs sharply from the usual process, which depends upon prices and competitive bidding.[3]

Controlling Total Quantities of Productive Agents. Finally, it is true that price relationships control, where possible, the total amounts of the agents of production which will be in existence in the long run. That is to say, a high rate of remuneration for an agent of production encourages an increase in its quantity, whereas a low payment leads to a decrease. However, it is not always possible to create more of an agent of production. In the case of land, for example, it is clear that rents and land prices may go up indefinitely without bringing about any increase in the quantity of this natural wealth.

In the case of labor, a theory held by classical economists, such as Malthus and Ricardo, suggested that the total quantity of labor was directly related to changes in wage rates. According to this theory, unusually high wages for labor would cause workers to have more children and enable them to rear large families to maturity, until these increases in the quantity of labor eventually caused wages to fall to, or perhaps even below, the subsistence level. If wages fell below the subsistence level, workers would have fewer children, or the disease and malnutrition that often accompany low standards of living would prevent the children from reaching maturity; the final effect would be a decrease in the total quantity of labor and a rise in wages to at least the subsistence level. The long-run result of these two tendencies would be to keep the wages of workers hovering around a level at which workers could only just maintain and replace themselves.

In modern times, this theory has been quite largely discredited. Indeed, some people hold to a theory which is almost the opposite, insisting that, if wages are raised, and workers become accustomed to higher standards of living, they will fight to retain these higher standards, even to the point of delaying marriage and practicing family limitation. Also, the necessity of getting along on the low standard of living that accompanies low wages is said to make workers imprudent, improvident, and careless of the morrow, so that they increase unduly the size of their families, and the future labor supply. In general, however, it seems that wage rates are less ef-

[3] Governmental controls over the allocation of labor among industries and businesses in wartime, as well as other governmental controls affecting labor, are discussed in chaps. 3 to 6, inclusive.

fective in controlling the total quantity of labor in the long run than in distributing the existing labor supply throughout our economy.

Capital goods result from saving and investment, and both of *hese processes are fairly responsive to changes in the rate of return 'ch is obtainable. Saving, of course, is done by many different of people and in response to a variety of motives. Many peo- ould save against a possible rainy day, even if there were no ing as interest. Some have such large incomes that they can ily since they feel no urge to spend all that they receive ear. Some savings are apparently made from force of habit, result wholly from the desire to provide for consump- ture time, and thus are not greatly influenced by the ate of interest.

onsiderations such as these, the fact remains that much ng which takes place is made only because of the financial n the form of interest. All saving requires the postpone- onsumption. Some families have such small incomes that involve considerable sacrifice to save even a very small nt. And those persons who would save something even if no nterest were obtainable can be induced to save more only by offering them interest; for the greater the amount saved out of a given income the greater is the pressure on the individual to spend the rest of his income for present consumption. It follows that a high rate of interest will sooner or later tend to call forth a larger total volume of savings than a lower rate, and that a reduction in the interest rate will tend eventually to cut down the total volume of savings. However, the effects of changes in interest rates upon the volume of savings are somewhat slow and uncertain. For in times of business depression and low interest rates, savings often continue to be made in considerable volume, while in prosperous times the total volume of investment in old and new enterprises often outruns the total volume of savings.

Investment is controlled more directly than saving by the rates of return that are obtainable. By investment we mean the use of savings for the purchase of capital for developing new industries or expanding old ones. The investments may be made directly by the savers themselves or by those who make a business of providing business men with funds. When business is good and old investments command high rates of return, new commitments are made

with alacrity and enthusiasm, even though the necessary postponement of consumption will mean considerable sacrifice, or the funds must be secured from others at considerable expense. Indeed, our commercial banks themselves often create purchasing power at such times so that additional investment may take place at a faster rate than would be possible if only new savings were used. When business is poor and old investments are paying unsatisfactory returns, people hesitate to make additional investments even though savings are available at low rates, and much of the existing volume of savings may be forced to lie idle until business conditions improve.

It appears, then, that the price system, by controlling the processes of saving and investment, provides a means of handling a problem which must be handled in some way in every economic order. The problem is that of deciding how our national income shall be divided as between the satisfaction of present wants through consumption, and the provision of facilities for obtaining a greater variety and abundance of economic goods in the future.

Theoretical Outcome of a Perfectly Functioning Price System. The results which we should expect to be attained if our economic system operated perfectly on the basis of price relationships may be summarized briefly. The members of society, as producers, would turn out precisely those goods which the members of society as consumers desired, and the relative quantities of the various items produced would be perfectly adjusted to the demands of consumers for them. The production of each economic good would be carried to the point where the last unit produced would command a price sufficient, and only just sufficient, to cover the cost and effort of producing it; at the same time, the consumption of each economic good would be carried to the point where the last unit purchased could be expected to produce a degree of satisfaction sufficient, and only just sufficient, to justify the payment of the price exacted for it.

Since, at this margin of production and consumption, both the anticipated satisfaction on the one hand and the cost or effort on the other would be equal to the same thing—that is, to the price of the good—they would presumably be equal to each other. However, since the units of the good which were produced up to this point of equilibrium could reasonably be expected to give more satisfaction than the marginal unit and to cost less than this unit, ideally the industry which produced the good in question—and, in like man-

ner, *all* industries—would control production so as to furnish society with the greatest possible surplus of utility over disutility (as represented by efforts or costs).

If the agents of production were allocated among firms and industries strictly on the basis of prices, their employment, under ideal conditions, would be perfectly coordinated with the desires of consumers as expressed on the market. No unit of any productive agent would be used for the production of a particular economic good if its use in producing some other economic good would result in a greater value-product or a higher rate of remuneration for the owner of the agent. Because of the apportionment of usable commodities and services among consumers on the basis of prices, no unit of any economic good would be purchased and consumed by any one individual if a greater marginal utility would result from its purchase and consumption by someone else, so far as marginal utilities are accurately measured by the willingness of individuals to pay prices on the market. Finally, the productive resources of the economy would be divided between providing for the present (through the production of finished commodities and services) and providing for the future (through capital formation) in perfect accordance with the time preference and desires of the people. In summary, the operation of the economy on the basis of the price system should make our scarce resources of production go as far as they could possibly be made to go toward the complete satisfaction of human wants.

Criticisms of the Price System

Criticisms of the actual operation of our economic system on the basis of price relationships usually embody two points of view. First, our actual economic system operates, on the basis of prices, with much less efficiency than does a theoretical model of capitalism. Second, even if the economy operated with perfect efficiency on a price basis, the result would not be the maximum satisfaction of human wants. The basis of this second criticism is the fact that money prices are imperfect instruments for measuring and expressing the relative strength of various human needs and desires and the costs of satisfying them. We shall turn first to criticisms of the efficiency of the price system.

The Apportionment of Finished Goods. Finished commodities and services must be apportioned among consumers by some

method or other, and it is fair to say that apportionment by means of price movements has proved a reasonably efficient method. The price of a good can always be made so high that the existing quantity, however small, will find—and only just find—takers. Similarly, a price can be made so low that enough buyers will be found to take off the market any conceivable quantity of a good. The amount by which price must change, to bring market demand and market supply into equilibrium, varies greatly from one good to another. If the demand is inelastic, the price has to rise greatly if it is to reduce the purchases of the good even slightly, and a great drop in price is necessary to induce buyers to take much more of the good than usual. If, on the other hand, the demand for an article is elastic, and the quantity available is much smaller than usual, a slight increase in price has the effect of discouraging many buyers; and if the quantity to be sold is larger than usual, a slight decline in price may be counted upon to increase sales greatly.

In actual practice, the apportionment of economic goods among consumers through price changes seems to work better in one direction than in the other. Rising prices are very effective in holding purchases down to a total which can be satisfied from existing stocks of economic goods, for sellers are glad to make this type of price adjustment whenever possible. But sometimes large stocks of goods pile up in the hands of producers and sellers, apparently unable to find a market. The reason, and the only reason, is that sellers are unwilling to lower their prices sufficiently to induce purchasers to take the goods off the market—because the sellers are unwilling to take a loss on the sale of their goods, are afraid of spoiling the market later on by selling at unusually low prices at present, or prefer to take their loss in some other form. Difficulties of this kind occur, then, not because apportionment by means of price changes is unworkable, but because producers and sellers are at times unwilling to let it work.

The Control of Production. Though there can be no doubt that the activities of business enterprisers in production are influenced by cost-price relationships, we must not expect to find production perfectly adapted to these relationships in practice. For one thing, the relative immobility of the agents of production obviously has an important effect upon the success with which production can be controlled on the basis of price relationships. Favorable or unfavorable cost-price relationships do afford a stimulus to the ex-

sion or contraction of the production of specific types of eco- goods; but adjustments of production to changes in demand brought about quickly and smoothly, because of the in- e productive agents to move readily from one place or another. And, all too often, before an adjustment of one change in demand can be completed, another mand may occur which will render the attempted ad- production inappropriate.

et conditions which prevail on the supply side of price tion are also important. It is only under competition that risers in any given industry, in reacting to increased de- favorable prices, may be expected to expand production ely that the price of the product will necessarily fall back t of production level. In controlling the affairs of their s, monopolists and monopolistic competitors must pay at- the demand for their products; but under any given con- of demand they have no incentive to carry production to the nt at which they can obtain prices which will merely cover the average cost of production per unit of their goods. Instead, they tend to limit output to the volume at which the marginal cost of producing the good is equal to the marginal revenue derived from its sale. Since such an output is ordinarily well short of that at which the price would be equal to the average cost of production, it follows that the productive results of operation under conditions of monopoly or monopolistic competition are quite different from those assumed in the general description of the control of production on the basis of price relationships.

Moreover, under conditions of monopolistic competition, products are differentiated and the individual enterpriser is in a position to control the market for his product to some extent. In such a situation, the enterpriser may decide that it will be better for him to try to "educate" the consumers to want and pay for the kind and amount of the good he considers it desirable to produce than to try to adjust his production to the supposed wants of consumers. The simple theoretical discussion of the control of production on the basis of price relationships tends to overlook the whole range of advertising and other economic activities which have as their purpose, at least in part, a change in the pattern of human wants rather than the satisfaction of wants which already exist.

The Apportionment of Productive Agents. Not only is production itself never perfectly adjusted to price relationships, but the

same thing is true of the apportionment of productive agents among industries and businesses. Once land has been committed to a particular enterprise or industry, it is ordinarily tied up for a considerable period of time and cannot be shifted promptly to other enterprises or industries, even though more profitable opportunities for its employment should arise. In similar fashion, when capital funds have actually been invested in fixed plant and equipment in some industry or other, and these capital goods will last for years, a change in price relationships which would make it possible for these funds to earn a greater return in some other type of investment will not cause them to move at once to another industry. Hence, for relatively short periods of time, a large part of the economy's capital funds is likely to be immobile, and, as a consequence, the distribution of funds among industries is unlikely to be perfectly suited to the price relationships which exist at a given time.

However, it remains true that, in the long run, all capital funds are mobile and none are permanently tied up in fixed capital goods. If savings will command more net interest in some uses than in others, or in some places than in others, after variations in risk and costs of administration are allowed for, it is to be expected that, in general, savings will move in the long run from occupations or places where net interest is low to occupations or places where it is high. That is to say, as capital goods wear out and make available liquid funds which might be used for their replacement, these funds will, if better investments are available, be transferred to other uses or places instead of being reinvested in new capital goods of the original type.

Differences and changes in wages are, even in the long run, sharply limited in their power to distribute labor among the many industries and occupations of a country. In some instances, workers may continue to accept a given wage, even though a higher one is being paid in another industry or area, because they are not aware of these better opportunities or because their acceptance of them is prevented by powerful unions. In other cases, they may know of the higher wage rates to be obtained in other occupations and be qualified for these jobs, but be unable or unwilling to take them because the better-paying jobs are beyond a reasonable commuting distance. The workers may be unable to pay the cost of moving themselves and their families to another place, they may have formed an attachment for their present location, they may have children in school whose opportunities for education would suffer in the new commu-

nity, or they may have homes which they could not sell except at considerable loss.

Still more important is the fact that the labor supply of a country does not consist of a single great mass of homogeneous units, all of which can compete freely with one another for employment in various occupations. Instead, the labor supply is divided into groups or classes, and the members of one group do not ordinarily compete with the members of another group. The high earnings enjoyed by investment bankers or corporation lawyers cause few, if any, hod-carriers to throw down their hods and study banking or law. They might easily lack the native ability to enter these pursuits, as well as the helpful factors of capital and social connections, and the necessary training might be difficult, if not impossible, for them to obtain. In short, a combination of hereditary and environmental factors tends to prevent free competition among different classes of labor, except in the occupations which are open to the members of a given group or grade of labor. This matter is discussed in detail in Chapter 4.

Controlling Total Quantities of Productive Agents. The method of controlling total quantities of productive agents by means of prices applies with real force only to capital, and even here the results produced are far from perfect. The total quantity of savings and capital often adjusts itself very slowly to changes in the interest rate. In times of inactive business, saving may take place to a considerable extent, even though the rate of interest has been declining steadily and the demand for funds to invest in industry is light. On the other hand, in highly prosperous times the demand for savings for use in financing new productive facilities may outrun the total quantity of savings, even though the rate of interest rises considerably.

The Influence of Business Depressions. In general, we must conclude that our economic system never operates with complete efficiency on the basis of price relationships. However, it operates with much greater efficiency at some times than at others, and is subject to periods of prosperity and depression. At times we are faced with the tragic spectacle of countless human wants going unsatisfied while many units of the scarce productive agents lie idle and wholly unproductive. Such periodic failures to use substantial portions of our agents of production while human beings are clamoring for goods represent, of course, a great economic waste.

The subject of business cycles is discussed at length in Chapter 12, but we may suggest here that business cycles are an almost inevitable characteristic of our type of economic system—that is, a system which depends upon specialized, large-scale, and roundabout production, self-interest, freedom of enterprise, private property in the agents of production, and the operation of the competitive price system. Specialization makes the different parts of our economic system highly interdependent, so that the maladjustment or breakdown of one important industry will affect adversely most, if not all, of the others. Large-scale production emphasizes whatever mistakes are made in adjusting production to demand; and indirect production, involving as it does a tremendous investment in fixed capital goods, tends to make such mistakes relatively permanent in character.

In an economic system which maintains freedom of enterprise and gives the individual an opportunity to follow his own economic self-interest, the decisions as to what to produce, when to produce, and how much to produce are made by a large number of independent individuals. Each, within rather broad limits, is left free to produce anything he pleases, at any time, and in any quantity that seems to him desirable, without regard to the demand for his and other products or the activities of other producers. The fact that most of these decisions which relate to production will become effective only in the fairly distant future introduces into the situation another opportunity for error. Under these conditions it would be little short of a miracle if an appropriate amount of each economic good were produced year after year; and under these conditions it is easy for industries to overdevelop and get out of adjustment with one another.

The Influence of Differences in Income. We turn now from the discussion of the imperfect functioning of our economic system on the basis of price relationships, to the contention that the system would produce imperfect results even if it operated with complete efficiency so far as price relationships are concerned. This argument rests upon the theory that money prices are not wholly satisfactory instruments for measuring and expressing human desires and the costs of satisfying them. We have said that, under the price system, the tendency is to produce each economic good down to the point where marginal efforts and satisfactions balance. This balancing of efforts and satisfactions does not mean much when the

parties to the transactions are from very different income levels. Consider, for example, the case of a well-to-do person who hires a domestic servant for thirty dollars a week. The employer desires the services of a domestic and considers the satisfaction to be derived from these services to be worth the price he must pay to get them. The prospective servant is capable of producing the required services and considers it worth while to expend the necessary effort in order to obtain the wages.

In spite of these considerations, there may be no real balancing of efforts and satisfactions in this case. The value of money per unit to the well-to-do person is so small that he may spend thirty dollars a week for a very moderate amount of satisfaction. On the other hand, the value of money per unit to the servant is so great that she will expend, for thirty dollars a week, an amount of effort which the rich man would not exert for a weekly stipend many times as large. Money prices cannot serve effectively as instruments for measuring efforts and satisfactions as between persons to whom the value per unit of money itself is quite different. It follows that, in our economic system, many agents of production are used for purposes for which they would not be used in an economic system in which money incomes were relatively equal.

The implications of such cases are obvious. Many efforts which now go into producing small satisfactions for the rich at high prices, instead of large satisfactions for the poor at low prices, would be transferred to the latter more important uses in an economy of equal incomes, with an increase in the surplus of total satisfactions over total efforts. This discussion, then, casts doubt upon the results obtained from the process by which consumers guide producers through the agency of prices. Accordingly to our previous analysis of this process, consumers express the high desirability or importance (to them) of certain economic goods by their willingness to pay high prices, while unimportant and non-essential goods can command only low prices. The high prices for certain goods attract enterprisers to these lines of production, and they in turn attract the other agents of production. In this way, it is assumed that our productive agents will be concentrated in the making of the economic goods which are most desired by consumers.

However, our discussion has shown that, when individual incomes are highly unequal, a high price for a given economic good may mean either that the good is greatly desired by its consumers or that the

consumers have such large incomes that they are willing to pay a high price even for a good which furnishes only a trivial satisfaction. On the other hand, a low price for a good may mean either that it is unimportant to its consumers or that the consumers have little money to spend for it or anything else, however badly the good may be needed. Business enterprisers are interested primarily in the existence of high and low prices, and not in the causes of such prices. Consequently, they are more likely to produce unimportant articles for the rich than important articles for the poor, if the production of the first is more likely to bring gains than the production of the second. On the basis of price relationships under capitalism, the production of economic goods is adjusted only to the effective demands of consumers in the market, and not to fundamental human needs or desires; for the demands of consumers, as expressed in terms of money, will not reflect human needs and desires accurately if individual incomes in the economy are highly unequal.

Underestimated, Complex, and Negative Wants. Even if all consumers had equal incomes, money prices would still not provide satisfactory expressions of all human wants and needs. In some cases, the difficulty is that consumers are likely to underestimate their real needs. It would be quite possible, we may suppose, for private enterprisers to furnish us with such services as fire protection and education on the basis of price relationships. But because of the great importance of such services from the social point of view, and because of the probable inadequacy of their production by private enterprisers on the basis of the prices which people would voluntarily pay, we take the provision of these services out of the realm of the free market and have them handled by public authority.

Some of our more complex wants seem incapable of being satisfied through the medium of the market and price mechanism. Take, for example, the matter of national defense, or the protection of our citizens from attack by external enemies. As one writer has said, "No device readily suggests itself by which such of the inhabitants of a given territory as were unwilling to subscribe to the cost of maintaining an army could be prevented from enjoying its protection in time of war; or which would adjust the amount of protection enjoyed by each citizen accurately to the amount that he chose to spend for this service." [4] Or consider the desire for economic secu-

[4] Barbara Wootton, *Lament for Economics,* New York, Farrar & Rinehart, Inc., 1938, p. 177.

rity, which is undoubtedly a matter of great importance to many persons. Clearly, "there is no way in which we can go into the market and, as it were, bid up the value of security, so as to stimulate the economic system to deliver more of this admirable product." [5]

Again, the price mechanism, as such, gives consumers no chance to express their negative preferences by bidding against the production and sale of certain commodities and services which they regard as undesirable. There may be many whose sum total of satisfactions would be much increased if they could prevent the publication and sale of a particular book or the production and sale of alcoholic beverages, noxious patent medicines, or other products, and who would be glad to pay prices to obtain such satisfaction of their negative preferences if an opportunity could be given them to do so. But there seems to be no way in which the price mechanism can take these negative preferences into account, and so we exercise these preferences, if at all, only through public (that is, governmental) action.

Unmeasured Costs. Finally, there is the problem of unmeasured costs. We have seen that, under competition at least, an enterpriser will ordinarily undertake to produce a good if the price he expects to obtain is sufficiently great to cover the necessary efforts of producing it, as these efforts are measured in terms of money costs. However, some of the actual costs to society of producing an economic good may escape measurement in terms of money. Suppose, for example, that a concern wants a tunnel excavated through a mountainside and signs an agreement with a contractor at a specified price. The contractor would not agree to this price unless he thought it sufficient to cover wages to workers, the cost of materials and supplies, depreciation of equipment, and the like; and the company would not agree to the price unless the service to be obtained appeared likely to warrant the expenditure. Thus, the undertaking would seem to be economically justifiable.

But the tunnel may have to be dug through solid silica, so that the workers are compelled to breathe the equivalent of finely ground glass, as in the once notorious Gauley Tunnel case. As a consequence, many workers may contract silicosis, a disease of the lungs which causes great suffering and often death to the victims. Someone has to pay for their care while they are incapacitated, and for the support of the dependents left by the early death of these work-

[5] *Ibid.*, p. 202.

ers. It is likely that society will have to bear the major part of these costs, which did not enter into the calculations of the company and the contractor when they were dickering over a price for the construction of the tunnel.

Manufacturers have sometimes decided to go into business and locate in given communities without reckoning as part of their costs, which the selling prices of their products would have to cover, the destruction of fish and pollution of the water supply which would result from pouring their industrial wastes into nearby streams. Similarly, the money costs of business enterprisers may take no account of the effects which the soot, grime, and smoke emitted by their factories may have on the health of the community's citizens, or on their laundry and house-painting expenses. In all such cases it appears that goods are actually produced in our economic system which might not be produced at all if their prices had had to be sufficiently high to cover all the costs incurred by society in producing them. In other words, certain goods which are being made may not yield enough satisfaction to justify their real costs, some of which usually escape measurement in terms of money. For these and other reasons, we should not be able to say that our economy had succeeded in making the scarce means of production go as far as possible in the satisfaction of human wants, even if the economy operated with complete efficiency on the basis of money prices in the market.

The Price System and Economic Problems

Our analysis and evaluation of the price system have suggested some of the problems which are to be considered in later chapters. Some workers, because of immobility, ignorance, or inertia, may work for wages which are below the marginal productivity of their services. Others, who may include millions of workers, although they are paid all their services are worth in the market, may yet have such low incomes that they cannot buy a decent scale of living and must endure insecurity with respect to the risks of accidents, illness, old age, and unemployment. Workers and employers, in quarreling over the proceeds of production, may bring hardship and economic loss to each other and to the general public.

Since our economic system operates with much greater efficiency at some times than at others, we must face the problem of business cycles and the closely related problem of changing price levels. Our

commercial and financial relations with other countries may either be allowed to rest on a market-and-price basis or be subjected to much governmental interference. Since some human needs and ˡesires can be satisfied only imperfectly, or not at all, on the basis the price system, we are likely to try to satisfy them through col- ᵗive action. This, however, raises the problems of what the func- ˋ of government should be, how much money should be spent ıem, and how the money should be raised. Great inequality e distribution of income among individuals and families is a al result of operating our economy on the basis of the price ɜm, and this inequality brings with it a number of problems. ɔome industries, such as railroads and public utilities, tend nat- ɾally toward monopoly, and their unregulated operation may have serious consequences for the general public. Monopolies may also be formed in other industries and businesses, with similar implications for the general welfare. The agents of production in some industries (as in agriculture, for example) may be singularly immobile and unresponsive to changes in price relationships, and unduly great productive capacity may remain in existence long after a decline in the demand for the products has occurred. Finally, after many individual economic problems have been considered, there remains the super-problem of whether we should retain our capitalistic economic system despite its shortcomings or replace it with a system of socialism, communism, or fascism, which might present even more baffling problems of its own.

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1. Explain the function performed by price changes in apportioning existing quantities of economic goods among consumers.
2. Would the problem of apportionment be important in a non-specialized economic system? Why?
3. "Existing amounts of economic goods may be apportioned among consumers either on the basis of prices or on the basis of physical quantities." Explain.
4. How is production controlled by the operation of the price system? Explain.
5. Why is the government likely to assume direct control over production in wartime? Explain.
6. How was production in the United States controlled by the government during World War II?
7. How are land and capital distributed among our various industries?
8. Does the operation of the price system distribute the existing labor supply among the various industries of the country? Explain.

9. Why and how did the government control the allocation of vital materials among industries during World War II?
10. Is the total amount of the labor supply subject to control by means of prices? Explain.
11. Is the total volume of savings controlled by price considerations? Explain.
12. "Investment is controlled more directly than saving by the rates of return that are obtainable." Explain.
13. Summarize the results that would be attained if our economic system operated perfectly on the basis of price relationships.
14. What is your estimate of the efficiency of the price system in apportioning finished economic goods among consumers?
15. What is the significance of monopoly and monopolistic competition in connection with the control of production by cost-price relationships? Explain.
16. "The apportionment of productive agents among industries and businesses is never perfectly adjusted to existing price relationships." Why?
17. What are the obstacles to the distribution of workers among places and occupations on the basis of differential wage rates? Explain.
18. How are business depressions connected with the operation of our economy on the basis of the price system and other capitalistic institutions? Explain.
19. Explain fully how differences in incomes help to prevent the perfect adaptation of production to basic human needs and desires under the price system.
20. "Even if all consumers had equal money incomes, money prices would not give us satisfactory expressions of all human wants and needs." Explain.
21. What is the importance of unmeasured costs in connection with the objective of obtaining maximum satisfaction at minimum cost? Explain.

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PROBLEMS OF LABOR

3. *Employer-Employee Relations*

In a capitalistic industrial society, commodities and services are produced under the control of business enterprisers. It is the enterpriser who assembles the agents of production—land, labor, and capital—essential to the operation of his business, and assumes responsibility for the profitable functioning of the enterprise. It is he to whom landlords, workers, and owners of capital must look for payment for the use of the several productive agents.

General Interest in Large Product. The various theories that profess to explain the distribution of income among the owners of land, labor, and capital are in agreement on at least one point, namely, that those who own these factors of production, if they are to be rewarded at all, must be paid out of the total product which results from the use of the productive agents. The larger the output produced with a given amount of land, labor, and capital, the greater is the probability of being able to collect a high price for the use of a given agent of production. In the distribution of income, as in geometry, the sum of all the parts cannot be greater than the whole. A factor of production cannot command a high price unless, through its use in combination with other agents, a large addition is made to the total product. Viewed in this way, production appears to be a cooperative enterprise, into which all parties concerned should enter with a right good will and work enthusiastically to attain the largest possible output.

Competition: The Basis of Industrial Conflict. And yet, in every economic system that operates under the rule of competition there appears to be economic conflict. Its most common manifestation is the disputes that take place between enterprisers and labor, that is, between the employers and their employees. The existence of employer-employee conflict is not difficult to explain. At its roots lies

the fact that, though there may be general agreement that society should produce the largest output possible, there is quite likely to be disagreement when it comes to the distribution of that product. For it so happens that enterprisers may think it desirable to increase their profits by keeping wages down, and labor, on the other hand, may favor an advance in wages that can be had only by encroaching on profits. Employers and employees are likely to differ, also, on such matters as hours of labor and working conditions.

The tendency for every man to look after his own economic interests is one that receives abundant encouragement in a competitive society. It is pleasant to be regarded as successful, and success is commonly measured in terms of income. Hence, employers seek large profits and employees high wages; and as a consequence they come to regard their interests as antagonistic—as, indeed, in large measure they are. Thus we find in all competitive economic societies the problem of industrial conflict, which arises from economic antagonism between employers and employees and makes itself known to the general public in the form of strikes, lockouts, boycotts, sabotage, and other militant measures.

Collective Bargaining

Individual vs. Group Action. Industrial conflict, then, appears to be the outcome of the competitive nature of employer-employee relationships. The terms upon which employers and employees join in productive activities, like the terms which are current in every field of competition, are the result of bargaining. Now bargaining of this kind may be either *individual* or *collective*. In individual bargaining, the terms of employment are arrived at through the employer dealing with his workers *as individuals;* in collective bargaining the negotiations take place between the employer and the workers *as a group*. Bargaining individually, the worker is at a great disadvantage for several reasons, the most significant of which is the fact that to the enterpriser one employee more or less means little, but to the worker a job is a matter of the utmost importance.

When bargaining is conducted on a collective basis, however, this disadvantage disappears. The worker's need for a job is no less urgent than before, but the employer's position is considerably changed. It is no longer a question of having one worker more or less, but of being able to secure a complete labor force or none at all. For collective bargaining means, to use the slogan of the Ameri-

can Federation of Labor, "one for all and all for one." The workers, banded together in a union, delegate to an official (usually the business manager of their organization) the right to bargain for them; and this official, with the authority to give or withhold the total supply of labor of a given kind, is naturally able to drive a much better bargain than the individual worker trying to bargain for himself. There can be no doubt that collective bargaining, in thus strengthening the position of the wage earner, does much to bring about equality of bargaining power between employers and employees.

Equalization of Bargaining Power. The social desirability of some degree of equality in bargaining power in employer-employee negotiations becomes apparent when it is realized that the alternative is to leave the economic fate of industrial workers almost wholly in the hands of their employers. And yet there are still a good many employers in America who hold that effective unionism is objectionable, and who oppose collective bargaining. According to the late Chief Justice William Howard Taft, such employers say, in effect: "It is my legal right to manage my business as I choose, to agree to such terms of employment as I choose, to exclude from my employment union men, because I don't approve of the tenets of the union, and to maintain a family arrangement of my own. I do fairly by my men; I pay them what I think is right, and they will not complain unless some outside union agent interferes. I run a closed non-union shop, and I am happy and propose to continue happy." Mr. Taft, who can scarcely be thought of as a radical, referred to the employer of this type as "the bourbon, the man who never learns anything and never forgets anything. . . . This man is far behind in the progress of our social civilization. . . . He does not recognize that we have advanced beyond the state in which employers and employees are mere laws unto themselves."

Labor Organization in the United States. The principle of collective bargaining has found very general acceptance in most of the older industrial countries, where the spirit of extreme individualism appears to be on the wane. In England, for example, not only are the workers encouraged to organize, but many of them also belong to the Labour Party, which was swept into power in 1945 and promptly began the nationalization of banking, mining, steel production, and other important economic activities. In the United States, labor organization has been less widespread than in England. Indeed, in certain industries (such as iron and steel manufacture,

and the production of electrical goods and automobiles) there was nothing that could be called effective unionization prior to 1936, when the Committee for Industrial Organization—which in 1938 adopted the name Congress of Industrial Organizations—began to unionize the workers in these fields.

The American Federation of Labor, the oldest group of organized workers in the United States today, has a membership of about 7,500,000 dues-paying workers, including John L. Lewis's United Mine Workers with some 600,000 members, who returned to the A.F. of L. fold in 1946. This number includes workers in hundreds of trades. The Congress of Industrial Organizations—popularly known as the C.I.O.—claims 6,000,000 members. There are several important groups not affiliated with either the A.F. of L. or the C.I.O. The railroad conductors, engineers, firemen, and trainmen make up the four powerful "Railroad Brotherhoods," with a combined membership of 442,000, and are directed by exceptionally well-informed leaders. The Trade Union Unity League, a communist organization, has a membership of approximately 60,000. The Industrial Workers of the World, which aims to "take possession of the earth and the machinery of production, and abolish the wage system," has about 10,000 members, largely among the itinerant harvest hands and lumber workers of the West. Other non-federated labor groups in this country have a total membership of some 350,000, but these organizations are not of sufficient size individually to warrant special mention. We have, then, according to the best estimates that are available, nearly 14,500,000 union members in the United States. The non-agricultural workers in this country, who make up the groups that might properly be termed "organizable," total some forty-three millions.[1]

Craft vs. Industrial Unionism. For many years, unionism in the United States was predominantly of the "craft" type, but since 1935 there has been a phenomenal growth in "industrial" unionism.

The craft union is an organization of workers in a given craft or trade, who join forces for the purpose of promoting the economic interests of the workers in this particular craft. The American Federation of Labor (though it has had some industrial unions) has

[1] Estimates of *organizable* and *organized* workers in the United States differ somewhat. The National Industrial Conference Board (*The Economic Almanac, 1945–46*, pp. 41, 174) estimated the 1946 "normal" labor force at 57,185,000, of whom about 15 per cent were agricultural workers. *The United States News* (January 4, 1946, pp. 36, 37) stated that there were 14,500,000 union members in our non-agricultural labor force of 43,000,000.

long been the stronghold of the craft type of organization, with each union made up of workers who do a specific kind of work. The result has been separate unions of bricklayers, photoengravers, machinists, cigarmakers, and a host of other kinds of workers.

In contrast to craft unionism is industrial unionism. An industrial union includes every man and woman working in a given plant or industry, regardless of the kind of work the person does. The United Mine Workers of America (which is again, as we have already noted, an affiliate of the A.F. of L.) is an outstanding example of the industrial union. On its membership rolls are the names of miners, pumpmen, electricians, carpenters, and workers of all kinds in and around a mine. The craft union operates *horizontally*, in the sense that it may cut across many plants or even industries. The industrial union operates *vertically*, since it takes into its membership *all* workers, whether of high or low degree, in a plant or a whole industry.

For workers who have mastered a skilled trade, the craft union may be the more effective form of organization. Carpenters, for example, may be able to bargain better as members of a carpenters' union than as members of an industrial union that includes all kinds and conditions of workers in (say) a given building project or the building industry as a whole. By restricting apprenticeship and by establishing other standard regulations throughout the trade of carpentering, they may be able, because they constitute a cohesive, limited group of skilled workers, to bargain with great effectiveness.

But the situation is different for many workers in the large-scale industries. In such industries, unskilled and semi-skilled workers are likely to be far more numerous than the highly skilled. In the field of mass production, specialization by trade has given way largely to specialization by task, and most of the tasks demand but little native ability and little training. As a consequence, a large industry may employ many thousands of workers whose skill is so slight that they have virtually no bargaining power, because as individuals (and even as separate groups) they could be readily replaced. However, when these separate groups of unskilled and semi-skilled employees join together in an industrial union, which includes also the relatively few but highly important skilled workers in a plant or industry, they become part of a strong agency for collective bargaining. In addition to the craft and industrial unions, we may note the

compound-craft (or associated-craft) union, which includes the members of several crafts that have related interests; and the semi-industrial union, in which are grouped some, but not all, types of workers in a given industry.

The A.F. of L. and the C.I.O. Of the 50,000 or more local unions in the United States, a relatively few remain purely local and independent, but the locals often join city, state, and national organizations. The national union is the sovereign unit, and the national unions sometimes "control such matters as strikes, working rules, negotiations with employers, and signed agreements, leaving the locals little more than administrative and dues-collecting units."[2] Though autonomous within their own jurisdictions, more than 100 national unions are affiliated with the American Federation of Labor, and about 40 national unions and organizing committees are allied with the Congress of Industrial Organizations.[3]

The A.F. of L. had its beginning in 1886, and had held the labor field for almost a half-century when John L. Lewis, president of the United Mine Workers of America, began a movement to organize non-union workers into industrial unions. Mr. Lewis and the leaders of eight other large unions formed the C.I.O. The movement made rapid headway, and soon included many unions in the steel, rubber, automobile, petroleum, textile, and other great mass-production industries. The progress made by the C.I.O. was highly distasteful to the American Federation of Labor. Mr. Lewis and his associates were charged by President William Green, of the Federation, with attempting to set up a rival organization composed of industrial unions; and the A.F. of L. unions which had allied themselves with the C.I.O. were expelled from the Federation.

The struggle between the A.F. of L. and the C.I.O. has had both good and evil consequences. The audacity and aggressiveness of the C.I.O. stung the somewhat lethargic Federation into action, and forced it in self-defense to start a campaign of organization which was long overdue. In expelling the unions that were pioneers in the C.I.O., the A.F. of L. lost about one-third of its membership, but in a few years of active organizing it secured more than enough new members to make up for this loss. The substantial net gain in A.F. of L. membership, and the several millions enrolled by the

[2] Richard A. Lester, *Economics of Labor*, New York, The Macmillan Company, 1941, p. 577.

[3] *Ibid.*, pp. 588, 593.

C.I.O. in its first half-decade, more than doubled the total number of union members in this country, and union membership doubled again during World War II. But for this gain a heavy price has been paid. The A.F. of L.–C.I.O. conflict is no longer a battle between craft and industrial unionism. It is, indeed, the bitterest kind of a struggle for power, with each side trying to set up rival unions in fields already occupied by the other. To some observers, this split in the ranks of labor seems likely to prove a serious blow to the American labor movement.

Employers' Associations. Business men, like their employees, have often formed local, state, and national organizations, and in many cases have used these organizations to resist the workers' efforts to establish collective bargaining. It is estimated that there are more than 7000 employers' associations in the United States. The largest and most influential is the National Association of Manufacturers, which includes in its membership some 3000 manufacturing concerns, many of which are among our largest employers of labor. Allied with the N.A.M. is the National Industrial Council, which is a federation of more than 200 employers' groups, some of which are national in scope and others state and local.

Not all employers' associations engage in open and vigorous opposition to effective unionization, but many of them do. By pledging their members, under penalty, not to enter into agreements with unions; by boycotting firms outside the association if they engage in collective bargaining; by undermining and destroying unions through the agency of labor spies; by establishing blacklists of "troublemakers"; and in sundry other ways, some employers' associations try to prevent the unionization of workers or to disrupt the unions once they become bothersome.[4] A less militant, but often effective, means of combating unionism is the introduction of "welfare" programs, health and sports activities, employee stock-ownership plans, employee representation, and other supposed "benefits" which are denounced by most union leaders as paternalistic. Of course, not all employers are unfriendly to collective bargaining, and, as we have said, some employers' associations do not actively oppose the unionization of workers. However, the attitude of the great employers' associations toward collective bargaining has, on the whole, been one of hostility.

[4] *Ibid.*, chap. 23. The reader will find in this reference specific examples of the policies and activities of employers' associations.

Union Aims and Methods

Recognition of the Union. There can be no collective bargaining, of course, until the employer stands ready to deal with his workers on a group basis. Many long and bitter strikes have been fought in the effort to establish the right to bargain collectively. Once this concession is granted to the workers, the union seeks, through its authorized representatives, to secure as great advantages as are obtainable in the way of high wages, short hours, and favorable working conditions. These three items form the essential features of the "trade agreement," or "labor contract," the formulation and acceptance of which are the prime object of all well-regulated unions.

The Trade Agreement. The trade agreement, which is usually though not always a written contract, is a statement of the terms of employment under which the members of the union are to work. A trade agreement may extend over a short period, such as six months, or it may establish the working arrangements that are to prevail for several years. Sometimes it consists of a contract between the union and a single concern, but quite often it sets forth the union's relations to all employers in a given industry within a specified district. Whatever variations may exist in these respects, it is customary for the trade agreement to deal with those phases of the employer-employee relationship that have already been mentioned—namely, wages, hours, and working conditions.

Standardization of Wages, Hours, and Working Conditions. Of these three items but little need be said other than to point out that it is quite understandable that workers should desire high wages, short hours, and working conditions that insure safe, pleasant employment and lead to strength rather than weakness in future collective negotiations. To this end, the members of a union agree upon a standard wage, a standard day's work, and standard working conditions having to do with sanitation, discharge, apprenticeship, and a host of other matters. By adopting the principle of standardization in regard to such items, and refusing collectively to accept terms less favorable than those specified, the workers are able to avoid the disastrous competition that often accompanies individual bargaining.

The Closed Shop and the Open Shop. But it is one thing to get employers to agree to deal with their workers as a group, and quite another to achieve the acceptance and actual execution of terms

of employment that are satisfactory to the members of the union. Experience demonstrates that a labor organization, if it is to win and hold the respect of business enterprisers, must be able to make a show of strength when the occasion demands. This display will be all the more imposing if the employer is confronted with the fact that his entire force of workers of a given type will go on strike if their demands are not met. Hence it is that labor leaders do their best to put into operation the "closed shop," which means that no union man is permitted to work in an establishment that hires non-union men in his particular trade or craft. Employers, on the other hand, often insist upon the right to run an "open shop," which is one that permits union and non-union men to work side by side, presumably without discrimination.

From the point of view of sound unionism, the closed shop is obviously superior, since it means that a failure to come to terms with the union will result in the employer losing all of his workers in a given craft (or, in the case of an industrial union, all the workers in a given plant or industry) down to the last man. Defiance of the union by an employer functioning under open-shop conditions might involve the loss of a part, say a half or two-thirds, but not all of his employees. As we shall see later, it is next to impossible to carry on effective collective bargaining in the absence of the closed shop. Since this is true, it follows that most unions insist upon the establishment of the closed shop just as soon as they have developed sufficient strength to enforce this demand. In the early part of 1945, approximately half of all union members in the United States were working under closed shop (or union-shop) conditions.[5]

The Strike and the Boycott. The closed shop is a powerful aid to a union in securing the adoption and fulfillment of a trade agreement favorable to the workers. But there are other measures that can be resorted to when necessary. The most effective weapon in the hands of the union is the strike, and, as has been suggested, its effectiveness is enhanced if the union officials can call away from their jobs all workers of a given kind in an establishment, as is the case under closed-shop conditions. The boycott, a less militant

[5] Harold W. Metz, *Labor Policy of the Federal Government,* Washington, Brookings Institution, 1945, p. 142. In the closed shop, only union members may be employed; in the union shop, an employer may engage a non-union worker, who must however join the union in order to be in a position to accept the job.

weapon, is an organized refusal on the part of union workers, members of their families, and union sympathizers in general, to buy commodities or services from business concerns that have been pronounced "unfair" in their dealings with labor.

Sabotage: An Industrial "Racket." Yet another instrument which may be used to convince the employer that it would be well to grant the demands of the union is "sabotage." Webster defines sabotage as "malicious waste or destruction of an employer's property by workmen during labor troubles." The workers, instead of going out on strike, may decide to *strike on the job,* that is, to remain at work and yet see to it that the employer feels their displeasure in a way that hurts. A monkey wrench slips into a costly machine and wrecks it, a batch of raw material is ruined by the addition of a quantity of acid, or a fire hose gets turned on mysteriously and soaks beyond all hope a thousand dollars' worth of finished goods. These and similar "accidents" that are calculated to bring a balky employer to terms cannot be condemned too vigorously. They do not constitute legitimate industrial warfare. Nor do the slowdown strike (in which the workers stay on the job but deliberately reduce their output) and the sit-down strike (in which they stop work entirely but refuse to leave the plant, though ordered out by the legal owners). Rather, these measures are on a par with the predatory tactics of the modern racketeer who destroys the property of any business man who refuses to buy "protection." In fairness to organized labor, it must be said that there are very few unions that deliberately engage in practices of this kind. On the other hand, there are likewise few that would not promptly and strenuously employ the orthodox strike and the boycott if their aims could not be realized through more peaceful measures.

Industrial Conflict and Public Welfare

The Attack on the Closed Shop. The effects of union activities upon public welfare may now be examined briefly, since any sound appraisal of unionism must be based largely upon the social consequences of the labor movement. What, for example, can be said in behalf of the closed shop, which has been so bitterly attacked by certain employers? The answer given by labor leaders and by disinterested students of labor problems is that effective collective bargaining appears to be dependent upon the adoption and enforcement of the closed-shop principle.

The Weakness of the Open Shop. The Railroad Brotherhoods have proved that effective unionism is not impossible with the open shop, but in general it may be said that the open shop does not provide the strong organization and unity of action that are essential to collective bargaining. If non-union men are permitted to work in the same establishment as union workers, sharing in all the benefits of high wages, short hours, and satisfactory working conditions that have been won by union action, there is but little incentive to take out or retain membership in the union, since union members have no privileges that are not enjoyed by non-union workers, except the rather doubtful one of paying dues. Thus the attempt to maintain an open shop leads almost inevitably to loss of membership, and consequently to loss of power in collective bargaining, since the latter is based ultimately upon the ability to wage a battle in case of necessity. Many a union has come to grief through the blighting influence of the open shop, or has saved itself from ruin only by shifting to the closed-shop basis before it was too enfeebled to make the move.

The Closed Union vs. the Open Union. The advocates of collective bargaining sometimes insist that the opponents of the closed shop are confused in their thinking—that they are wasting their time and effort in fighting an essential and socially desirable device of unionism, the closed shop, whereas in reality they should be concentrating their fire on the "closed union." For the closed union holds grave possibilities of being socially harmful, since it may be used to restrict the number of workers that will be permitted to enter a given trade, and thus bring about an artificially high level of wages.

The "open union" is one which aims to enroll in its membership all workers belonging to a craft or trade, such as bricklayers, carpenters, or cigarmakers. Membership is made attractive by the establishment of small initiation fees and low annual dues, and the test of craftsmanship may consist merely of a man's ability to secure a job from an employer. The closed union, on the contrary, seeks to limit its membership by charging high initiation fees [6] and dues,

[6] "Some unions have such high admission fees that it is almost impossible for the average man, no matter how well qualified, to join. The truckers in Seattle, for instance, charge $500. The Motion Picture Union in Cleveland grabs $1000. And the Glaziers' Union in Chicago demands a cool $1500 for the right to work."—Thurman W. Arnold, Assistant Attorney General of the United States, in *The Reader's Digest,* June, 1941, p. 139.

and sometimes by requiring the candidate to pass a rigid examination in the craft in which he claims proficiency and be approved by vote of the existing membership of the union. It will readily be seen that requirements such as these can be made the means of exclusion from the union whenever its members feel that it is unwise to add to its numbers. The result is a limitation upon certain types of labor, and abnormally high wages for those types; but labor in general does not share in these wage benefits. The public, of course (including all labor that is not similarly organized), pays the bill, just as the public pays whenever an enterpriser in a monopoly position restricts the supply of his commodity and thus forces up the price. The closed union, then, may be quite as injurious to public welfare as the monopoly control of commodities or services. To control the situation, the closed union must, of course, include within its membership a large proportion of the total workers in the trade. This statement is applicable also to the open union, since neither type of union could hope to maintain a closed shop if large numbers of competent non-union workers were looking for jobs.

The Open Union with the Closed Shop. It is the open union operating under the closed-shop principle that most students of labor problems regard as the best form of labor organization that has yet been devised. If the union is genuinely open, it has no limiting influence upon the supply of labor. If the supply should be small and wages high as a consequence, there will be a tendency for workers to be attracted to the trade; and if all are to find employment the wages will have to come down, unless we suppose an increase to have taken place in the demand for labor of this kind. It is in this respect that the open union is socially preferable to the closed union, as was noted in the preceding paragraph.

Having been taken into the union, the new members are perfectly free to work in the closed shop. Indeed, the union frequently acts as an employment agency for its members. Thus the combination of open union and closed shop does not deny an employer the privilege of engaging any worker who is willing to acknowledge labor allegiance to the extent of joining the union and paying dues. What it does, rather, is to set up uniform conditions of employment, make possible collective bargaining, and insure that all who benefit by the union's activities shall have a part in bearing its expenses. In a word, it provides a self-supporting agency through which the worker is enabled to overcome the handicap which he suffers when forced to bargain as an individual.

It will be well, at this point, to emphasize the fact that the open union with the closed shop cannot hope to win for the workers, at a given time, anything more in the way of favorable wages, hours, and working conditions than would tend to come to these workers *in the long run* and *under competitive conditions* even in the absence of a union organization. But this, after all, is a good deal. Readjustment which under individual bargaining might be effected in the "long run" can sometimes be made in the "short run" through collective bargaining; and competition, which tends to become sluggish when there are great inequalities in bargaining power, is stimulated into action when workers organize an open union and enforce the closed-shop principle. Economic theory speaks of the tendency of wages to equal the marginal productivity of the worker. An open union with a closed shop does much to convert this tendency into a reality. Functioning properly, it enables the worker to secure his *full competitive wage,* which he can seldom secure without collective action. Similarly, it enables him to command his full competitive share of short hours and good working conditions. Collective bargaining of this kind is valuable, then, in obtaining for the worker those benefits to which the existing conditions of supply and demand entitle him—benefits which he is usually unable to secure, however, when he is compelled to contend individually with the superior bargaining force of the employer.

Limitation of Output. Unions are often charged with restricting output by insisting that their members turn out no more than a specified number of units of product per day, or, again, by fighting for a shorter working day or week. It is true, unquestionably, that unions do endeavor to cut down the amount of time that workers shall be compelled to give to industry. Owing largely to union pressure, working hours have been reduced from twelve to ten, and again from ten to eight in a great many businesses, and there is much talk of still further reductions. In some instances, indeed, these further reductions have already been made. The United States Bureau of Labor Statistics reported, for example, that in 1928 there were thirteen crafts in this country that were on the 40-hour week in one or more cities. With the introduction of the so-called "New Deal" in 1933, the working week of American workers in general was shortened materially, in some instances being reduced to thirty hours. According to the National Industrial Conference Board, the *average* actual working week of the employees in twenty-five manu-

facturing industries was 38.7 hours in 1937, but this figure rose, under the stimulus of war, to 45.6 in 1944.[7] It is probable that, in most trades, a shortening of the working day and week does not bring a proportional loss in production. It is certainly true, as has been proved by actual tests, that a reduction in working time *may* result in a larger rather than a smaller output per dollar of wages paid. There is serious doubt, however, that the working week could be reduced to thirty hours without loss of output; but in any case it seems reasonable that the workers should share in industrial progress not only through the receipt of larger wages, but also in the enjoyment of greater leisure. This, at any rate, is the stand taken by labor leaders, and it is one that is not easy to combat. The 40-hour week has been widely adopted in the United States,[8] and the 30-hour week has had the endorsement of American organized labor.

Regardless of the exact number of hours to be worked, should not each worker be expected to produce his maximum output per hour or day? The business man's reply is usually an emphatic affirmative, but the spokesmen for the unions raise several objections to this conclusion. They point out that it is the duty of the union to safeguard the business interests of *all* its members; that if every worker produced to the utmost of his capacity the employer would try to make the output of the *best* worker the standard task for the group; and that under these conditions the *average* worker would be "sweated"—that is, worked far beyond a reasonable point, and perhaps beyond his powers of endurance. The remedy, from the union point of view, is standardization of task, and this means almost necessarily a standard task that can be attained by the average worker. It is better, the unionists believe, for a few men to be underworked than for many to be sweated.

This argument may not appear wholly convincing to a consuming public that has to pay somewhat more for its commodities and services under union regulation than would be charged if employers were free to drive their workers. But unionists can point to many instances of exploitation of labor in the absence of standards set up and enforced by collective bargaining. In the face of the apparent necessity for the protection of workers in this respect, it is difficult

[7] *The Economic Almanac, 1945–46,* New York, National Industrial Conference Board, 1945, p. 197.

[8] Note, in this connection, the 40-hour maximum placed upon firms engaging in interstate commerce, as provided in the Fair Labor Standards Act of 1938, which is outlined later in the chapter.

to make out a strong case against the standard task, unless the standard that is set is ridiculously low. So long as there is conflict of interest between employers and employees, the workers can scarcely be expected to surrender a powerful weapon of defense such as standardization has proved to be, even though its retention may involve some loss to society at large.

Business Men's Practice of Limitation. Restriction of output, incidentally, is a subject in which some business men could easily give lessons to workers. It is certainly not demonstrable that enterprisers feel impelled always to turn out the maximum amount of product. On the contrary, it is a very common practice—and, it may be added, a thoroughly "respectable" one in business circles—to manipulate output in a manner dictated by the enterpriser's economic interest, that is, on the basis of profit. If a large output gives promise of the maximum profit, a large output will be produced; but if more is to be made by restricting output, business men ordinarily do not hesitate to engage in restrictive practices. This statement is not intended by way of justification of limitation of output by either employers or employees. It is merely a statement of fact, designed to indicate that if standardization by unions *incidentally* brings about restriction of output, it should not on that account be condemned too heartily until we have successfully disposed of *deliberate* limitation of output on the part of business enterprisers.

One form of restriction practiced by business men is the purchase and "shelving" of patents on new machinery which, if put into use at once, would reduce the costs of production of certain commodities and permit their sale to the public at lower prices.[9] The reason for wishing to delay the introduction of the cheaper processes lies usually in the existence of capital (that is, machinery) which has in it some years, and often many years, of further usefulness. It is often "good business," from the enterpriser's point of view, to postpone the use of the improved device until the existing equipment has worn out, even though the postponement is costly to the consuming public.

Labor's Opposition to New Machinery. A parallel to this type of restriction is found in the opposition of unionists to the introduction of labor-saving devices that threaten to take away their jobs, or that at best are likely to force them to accept wage reductions. Thus,

[9] See, in this connection, Floyd L. Vaughan, *Economics of Our Patent System*, New York, The Macmillan Company, 1925, chap. 6; also, *The United States in a New World*, supplement to *Fortune*, December, 1942, p. 12.

the Journeyman Stone Cutters' Union fought bitterly the mechanical planing of stone, the Glass Blowers' Union opposed the introduction of the Owens bottle-making machine, and the American Federation of Musicians has battled and is still battling against the "canned music," recorded and reproduced by mechanical devices, which, if its use went unrestricted, might virtually wipe out the demand for theatrical and radio orchestras.

It may be that methods will be found for the gradual replacement of old machinery by new, with only slight loss to business men through the scrapping of usable capital, or to labor through the obsolescence of acquired skill. On this point we shall have more to say in Chapter 5. For the present, it is not inappropriate to quote the old proverb, "What is sauce for the goose is sauce for the gander," and to suggest that it is scarcely consistent to condemn skilled workers for opposing the installation of new machinery unless we are equally critical of business men who buy up and smother patents on new and better processes in order to avoid the sudden obsolescence of industrial capital.

Unemployment and Restriction of Output. Another cause of limitation of production indulged in by both organized and unorganized workers is the fear of being laid off temporarily. This, again, is a subject with which we shall deal in our treatment of economic insecurity. But it may be observed here, in passing, that to most industrial employees, union and non-union alike, the paramount issue in life is getting and holding a job. This being true, it is not surprising that the possibility—even the remote possibility—of layoff through a lack of work should lead workers to indulge in "soldiering," that is, producing less than could be produced in a given time, in order to make the job last just as long as possible.

He would be a self-denying worker, indeed, who deliberately "worked himself out of a job" by producing the maximum output, when by lessening his efforts he could be sure of drawing wages over a longer period of time. Society suffers, of course, by the adoption of such tactics; but perhaps a society that does not attempt seriously to solve the problem of layoffs deserves little sympathy if its neglect of the problem carries the penalty of high prices through limitation of output. At any rate, as we have noted, soldiering on the job in order to delay the evil day of unemployment is by no means confined to unionists. It is practiced consistently by all workers who believe in that cardinal principle of the competitive system—that it is the duty of every member of society to seek first his own self-

interest. Doubtless all restriction of output is bad, whether practiced by employers or employees, but a means has not yet been found whereby restriction can be abolished in an economic system motivated by a desire for individual gain.

The Use of the Strike. The strike is a concerted withdrawal of workers from an establishment, and is a move designed to force an employer to grant his employees better terms than those under which they have been working, or to compel him to withdraw an unpopular ruling such as a cut in wages or an increase in hours. The strikers are always hopeful that their action will cause the employer to concede the point at issue and thus make possible the resumption of business relations and operation of the plant. A strike does not mean, then, that those who take part in it have relinquished all claim to their jobs. On the contrary, workers on strike invariably regard the temporarily abandoned jobs as belonging distinctly to them; and the acceptance of this idea is fundamental, for otherwise the employer might hold that there was no strike in progress and hence no need for negotiation. It follows that workers on strike object most strenuously to any attempt of the enterpriser to replace them with a new working force. Probably no one in the industrial world is more thoroughly despised than "strikebreakers"—the workers who are sometimes hired temporarily by an employer in the effort to discourage the strikers and get them back to work on his own terms.

Public Attitude Toward the Strike. Non-union workers have been known to go on strike; but since success in this phase of industrial conflict demands united action, it is among the unionists that strikes are most common and most effective. The strike is the most spectacular form of industrial warfare; and since the workers, in going on strike, take the initiative and act as aggressors, it is perhaps to be expected that the general public should jump to the conclusion that strikers are troublemakers, that their demands are probably unreasonable, and that they are entitled to little sympathy. Though the accounts of strikes as written by newspaper reporters are likely, on the whole, to be fairly impartial, they are sometimes modified at the request of the advertising department. Certainly the editorial columns are more likely to reflect the economic views of the publisher, and the indignation of the outraged employer and irritation of the local police, than to present an unbiased and dispassionate analysis of the situation giving rise to the strike.

The attitude of society toward the strike and strikers is affected

by the fact that recourse to this weapon often brings inconvenience, and sometimes actual suffering, to the consuming public. An actors' strike means closed theaters, a railway workers' strike brings interruptions in transportation, a miners' strike forces the use of bituminous coal and coke in place of the desired anthracite, and so on. Particularly in the case of public utilities is it easy for incommoded consumers to get the notion that the strike is an evil institution, and that those who invoke and prosecute it are enemies of society. Whether the public's interest in securing an uninterrupted supply of commodities and services should lead to the outlawry of the strike is a question to which we shall give some attention later in the present chapter.

Economic and Human Costs of the Strike. The inconvenience experienced by consumers when workers go on strike is only one of the many costs imposed upon society by industrial strife. This is a form of cost that cannot be measured with any degree of accuracy. Probably we are justified in suggesting that strikes do not, as a rule, cause the public any great amount of suffering. And yet the possibilities of injury to health through the non-delivery of such essentials as milk or coal, to life and property in the event of a strike by the police or other public servants, and to national safety if there is a stoppage of work in airplane or munitions plants, cannot be ignored.

In the editorial comments on strikes, much is usually made of the economic costs borne by workers in the loss of wages and by employers in the loss of profits. These costs are often exaggerated, and yet, despite the absence of exact data, we know that they run into many millions. According to some estimates, in the General Motors strike of 1945–46, the workers lost in wages during the strike more than the contested amount would total in five years of post-strike employment; but this was scarcely a typical case, and in any event it is possible that the *long-run* benefits of the strike more than justified its cost to the strikers. According to the Bureau of Labor Statistics, there were 20,176 strikes in the United States in the decade from 1930 to 1939, inclusive, with a total of 9,115,754 workers involved, and a loss of 142,627,000 man-days. If the average wage was only five dollars a day, the loss in the earnings of workers was $713,-135,000—and this quite apart from the enormous losses the employers must have suffered. Though these losses bulk large in the aggregate, they are less imposing when spread over the years in question and divided among the millions of workers. Indeed, we find that these

strikers lost, on the average, only slightly more than $46 each in the ten-year period. This may have been far less than the average gain realized by the workers through going on strike, though on this point we have no information. Nevertheless, since the figures represent pure *social* loss, they suggest the economic desirability of the elimination of strikes.

Yet another social cost chargeable to strikes is the loss of life that occasionally accompanies militant activities in industry. When strikers are lined up on one side of the contest, straining every nerve to win a victory that will insure satisfactory, remunerative jobs, and armed guards, detectives, and strikebreakers are arrayed against them, it is not an easy matter to prevent violence. Indeed, in view of the opportunities for trouble that such a situation presents, surprisingly little violence occurs in connection with strikes. There are, to be sure, such bloody encounters as the "Ludlow massacre" and the "Herrin massacre," in which there was wholly inexcusable loss of life.[10] In the main, however, American strikes have been conducted with comparatively few fatalities.[11]

The Industrial Lockout. The "lockout" is much less spectacular than the strike, but it constitutes an act of aggressive warfare on the part of the employer, just as the strike is an act of aggression initiated by the workers. In the lockout the employer closes his doors and does not open them again until the workers come to him suing for peace and ready to accept his terms of employment. This action, it will be observed, has precisely the same social consequences as a declaration of strike by the workers; that is, it immediately puts a stop to production and thus interferes with society getting the goods it wants. The strike and the lockout are alike, moreover, in purpose. The object of each is to force the party against whom it is directed to agree to terms dictated by the aggressor, whether the latter is an

[10] At Ludlow, Colorado, on April 19, 1914, a group made up of militia and mine guards—the latter in the pay of the Colorado Fuel and Iron Company—opened fire on a tent colony of striking miners, and a few hours later burned these temporary homes of the miners to the ground. Twelve children and two women lost their lives in this "massacre." At Herrin, Illinois, during a strike against the Southern Illinois Coal Company, three union workers were killed in a pitched battle between strikers and mine guards on June 21, 1922. On the following day sixteen of some sixty strike breakers who had surrendered were killed by an armed mob, despite the fact that they had been promised safe conduct out of the county.

[11] The problem of wartime and post-war strikes is discussed later in the present chapter.

employer or a union. The strike and lockout are so similar in purpose, in method, and in social consequences that it is scarcely possible, with consistency, to oppose one and at the same time endorse the other.

Employer Attitudes Toward Unionism

The Open-Shop Movement. A good many American employers regard collective bargaining as desirable and inevitable, but this attitude is far from universal. Much of the opposition to unionism has been passive, but some large-scale employers of labor have taken an active part in the fight by joining in the "open-shop campaigns" waged by such organizations as the National Association of Manufacturers, the Chamber of Commerce of the United States, and the National Metal Trades Association. By means of addresses made by paid speakers and the distribution of tons of printed matter, the "American" open shop has been lauded and the "un-American" closed shop roundly condemned.

To the charge that the closed shop is un-American, the unionists retort that, on the contrary, it is as distinctively American as any institution could possibly be. They insist that there can be nothing even approximating democracy in American industry unless the workers are strongly organized, and that powerful unions are out of the question in the absence of the closed shop. They argue, further, that the closed shop is democratic and American because it forces all who benefit by union activities to pay dues, and thus to contribute to the costs of achieving progress, whereas the open shop allows the unionists to pay the bills, while non-union workers, who are equally well off financially, enjoy the benefits gained through union efforts but make no payments.

In these verbal disputes, it would seem that the unionists have the better of the argument. They have found the weak spot in the armor of those employers who profess to believe in unionism but who specify that it must be a unionism which, by its very nature, is so weak as to be virtually useless. When employers talk about endorsing unions and yet insist upon the open shop, they indicate that they are looking for credit without performance—that they are seeking a reputation for friendliness to organized labor while in reality they are antagonistic to the development of union power—for effective unionism is practically impossible in conjunction with the open shop.

The Company Union. The "employee representation" movement, which has developed in the United States during the past thirty years, is regarded by many as an attempt to weaken unionism of the militant type by the introduction of a harmless variety known as the "company union." The company union is one that comes into being with the full consent of the employer; and prior to the passage of the National Labor Relations Act it was ordinarily initiated and financed by him. Under company unionism, or employee representation (for the terms may be used interchangeably), the workers in a given establishment elect representatives from among their number to meet at stated times with representatives appointed by the employer. At these meetings it is possible to raise questions of hours, working conditions, and (in rare instances) wages. The theory is that through these friendly councils the wishes of the workers will become known, misunderstandings cleared up, abuses remedied, and a spirit of cooperation built up.

A survey of the situation shows that company unionism has been successful in improving labor relations in some instances, and has met with failure in others. It has been warmly endorsed by many employers and by some disinterested students of labor, but is openly and bitterly condemned by the independent unionists. The strongest argument against the company union is the impotence of its members in the face of opposition on the part of the employer. Unlike the independent union, it is not able to press its claims when they run counter to the employer's wishes.

Employee representation does provide a means of frequent intraplant conference which may be a valuable aid to production and the maintenance of good will. It lacks, however, that prime essential of true democracy—"power in the hands of the people"—and it is largely because the company union leaves its members powerless in time of emergency, and dependent upon the benevolence of the employer, that it has aroused the enmity of thoroughgoing unionists. The unionists, moreover, regard the employee representation movement as a device for undermining strict unionism. They have watched with apprehension its gain in adherents. According to the best estimates available, workers to the number of two to three million now belong to company unions in the United States. This does not mean, however, that these are workers who have deserted independent unionism and gone in for company unionism. They are, for the most part, workers who were formerly unorganized and who now

appear under the company-union banner because their employers have put into operation systems of employee representation. Nevertheless, the orthodox unionists have always regarded company unionism as a threat to independent unionism, and have fought it vigorously ever since its inception.

The "Yellow-Dog" Contract. One very objectionable feature of certain employee representation plans, from the traditional union point of view, was the requirement that every worker sign a contract agreeing that, while in the employ of the concern, he would not join a trade union, and sometimes even promising not to associate or confer with union leaders or members during his term of employment. To this type of contract the independent unionists gave the name "yellow dog," because (to quote an official statement of the American Federation of Labor) this contract, "like the proverbial alley cur, is a menace to the community in which it exists."[12] Whether this statement is strictly accurate or not, there can be no doubt that at one time the yellow-dog contract constituted a distinct menace to unionism. Not only could a company, by virtue of this contract, discharge an employee who violated his agreement by joining a union, but employers sometimes succeeded in having court injunctions issued, restraining union representatives from attempting to organize their employees on the ground that to undertake such organization would be an attempt to induce breach of contract.

The leaders of labor promptly recognized the fact that if the yellow-dog contract were allowed to stand, and if it were used to prevent union organizers from carrying on their work, it would be a real blow to unionism. Hence, they marshaled their forces against it, and were able in this struggle to enlist on the side of labor the hearty support of a large part of the general public. A half-dozen states passed laws declaring the yellow-dog contract unlawful. Several state supreme courts pronounced such legislation constitutional, but others declared it unconstitutional. The Supreme Court of the United States, in passing on a similar issue in 1917 and again in 1921, apparently upheld the legality of the yellow-dog contract, basing the decisions on the "freedom of contract" provisions of the Constitution.

In 1929 and later years, many of the states passed laws which,

[12] *Report on Proceedings of Forty-seventh Annual Convention,* October, 1927, Washington, American Federation of Labor, p. 291.

while they did not forbid the use of yellow-dog contracts, made such contracts unenforceable in the courts. The Norris-La Guardia Act of 1932 declared such contracts to be contrary to the public policy of the United States and non-enforceable in the federal courts. The National Labor Relations Act, passed in July, 1935, forbade the use of yellow-dog contracts by firms engaging in interstate commerce. This Act was declared constitutional by the United States Supreme Court in 1938.

The Labor Injunction. We have referred to the use of judicial injunctions in connection with the enforcement of the yellow-dog contract. This was one of the most serious applications of the injunction to labor disputes, but it was, after all, only one of the many uses to which the "labor injunction" has been put.

> Intended originally to protect property from irreparable damage during a strike or boycott, the injunction has been called upon to perform a much wider service. Union workers and officials have at times been forbidden, by court order, to urge non-unionists to join a union even in the absence of a "yellow-dog" contract, to picket, to publish information regarding the progress of a strike, to pay strike benefits, or to perform any other act which might, in the opinion of the court, lead to certain undesirable results. Obviously, injunctions of this type, if observed, destroy almost completely the power of the strike; for employers can always find accommodating judges ready to issue injunctions that will bring all strike machinery to a stop. One of the most serious consequences of this alleged abuse of the power to enjoin is a widespread loss of confidence in the integrity of the courts. It is getting to be a commonplace among working people that the courts and the police authorities are always to be found on the employer's side in an industrial dispute.[13]

The frequent use of judicial injunctions in industrial conflict was long a source of great anxiety to labor leaders. The Norris-La Guardia Act of 1932, to which we referred in our discussion of the yellow-dog contract, is sometimes called the "Norris-La Guardia Anti-Injunction Act," because its provisions restrict the use of injunctions in industrial disputes. This Act prohibits the issuance of restraining orders except under unusual circumstances, and then for periods longer than five days. No injunction may be granted without an oral hearing in open court. A person charged with contempt in connection with the violation of an industrial injunction is entitled to trial by jury, unless the contempt was committed in the presence of the

[13] Paul F. Gemmill, *Present-Day Labor Relations,* New York, John Wiley & Sons, Inc., 1929, p. 17.

judge, and he has a right to be tried by a judge other than the one who issued the injunction. There are further provisions in the Act designed to protect the workers' rights in labor disputes.

The National Labor Relations Act. The National Labor Relations Act (or Wagner Act), which we have mentioned several times in the present chapter, requires employers to bargain collectively with the representatives of their employees, and prohibits employers from interfering in the organization of agencies for collective bargaining and from engaging in unfair labor practices. It provides for the administration of the law by the National Labor Relations Board, which has the power to investigate, to settle disputes, to issue orders to employers, and to have these orders enforced by the federal courts.

The Act was designed to encourage the speedy organization of workers into bargaining groups, and to require employers to bargain collectively. Its success in this respect is indicated by the enormous increase in union membership which followed the enactment of the law in 1935. Any attempt on the part of employers to interfere with the operation of the Act may be made the subject of a hearing by the Board, which, if it sees fit, may then issue a "cease and desist" order against the offender. "It deals with only one segment of labor policy," explains one writer. "Its limited purposes are to protect employees against employer interference with their right to form and join labor unions, and to encourage collective bargaining between employers and bargaining agents representing a majority of employees in an appropriate bargaining unit." [14] By the very nature of the Act, the disputes handled by the Board are charges of unfair practices brought against employers, and not the usual labor disputes centering about wages, hours, and conditions of work. On this account, the Act and the decisions of the Board have often been called "one-sided"—and this they clearly are, in the sense that they make demands upon employers but not upon workers. The answer is that the obvious intent of the Act was to lessen the inequality of bargaining power as between workers and employers, and that this can be done only by strengthening the former at the expense of the latter.

Despite the charge of one-sidedness, it appears that the National Labor Relations Board has not dealt out justice with undue harshness. In its first five years of operation, more than 95 per cent of the

[14] Ludwig Teller, *A Labor Policy for America*, New York, Baker, Voorhis & Company, Inc., 1945, pp. 36, 37.

complaints registered with the Board were disposed of by withdrawal, dismissal, settlement, or compliance. Of the comparatively few cases which were appealed to the Supreme Court during this period, the Board's judgments were fully sustained in twenty-three cases, partially sustained in five, and overruled in but two.[15] In a three-year war period ending September, 1944, 82 per cent of the cases handled by the Board did not require the invoking of formal procedure, and eight of the nine cases that reached the United States Supreme Court were decided in the Board's favor.[16] This record would seem to suggest that the Board has administered the Act with a high degree of restraint. It may also be noted that one of the few agreements which came out of the government-sponsored Labor-Management Conference, held in Washington in the latter part of 1945, related to the Labor Relations Board. In opposing the proposed absorption of the Board by the Department of Labor, management and labor agreed upon the following significant statement: "To the end that the National Labor Relations Board may be enabled best to perform its functions in the prompt and impartial determination of representation questions, the Board should remain as an independent agency, and should be provided with adequate appropriations."

Federal Legislation on Wages, Hours, and Child Labor. The Fair Labor Standards Act of 1938 (often referred to as the Wages and Hours Law) became effective on October 24 of that year. Its purpose is to protect, to some extent, low-income workers who find it especially difficult to protect themselves because they lack bargaining power—or, as its sponsors are fond of saying, the Act aims to put "a floor under wages and a ceiling over hours."

The Act made it unlawful for an employer whose products move in interstate commerce to pay less than 25 cents an hour, or to work an employee more than forty-four hours a week without payment of "overtime" in cash at the rate of "time and a half." After one year, the maximum hours were to be reduced to forty-two a week, and the minimum wage raised to 30 cents; and this process was to continue until 1945, when the maximum hours would be forty a week and the minimum wage 40 cents an hour. However, the administrator of the Act was empowered to appoint industrial committees to investigate conditions in specific industries and, upon recommenda-

[15] Richard A. Lester, *Economics of Labor,* p. 722.
[16] *Labor Fact Book 7,* New York, International Publishers, Inc., 1945, p. 118.

tions of these committees, to order more rapid decreases in maximum hours or increases in minimum wages.

The Act also dealt with the subject of child labor, specifying that in industries engaged in interstate commerce no child under sixteen years of age could be employed, and none under eighteen years could be employed if the work was "hazardous or unhealthy."

It is estimated that the Act affected, in the first year of operation, some 750,000 workers as regards wages, and about 1,500,000 in the matter of hours. As time passed, the progressively lower maximum hours and higher minimum wages have brought additional groups of workers under the law; and the tendency to amend the Act by raising the minimum wage to 65, 70, and 75 cents an hour makes it fairly clear that many millions of workers will eventually benefit. However, this Act, like the Social Security Act (which we shall discuss in Chapters 5 and 6), falls far short of universal application. For it exempts from the provisions of the law employees engaged in administrative, executive, professional, local retailing, and outside selling activities; employees of retail or service establishments when predominantly intrastate in character; seamen, fishermen, agricultural workers, employees of air transport companies, street car or bus lines, and certain other businesses.

An immediate reaction to the enforcement of the Act was the discharge of some extremely low-paid workers in the pecan-shelling industry (which had been paying as little as five cents an hour, and from $2.00 to $2.50 for a full working week), and in certain tobacco plants, lumber mills, and clothing factories, chiefly in the South. It is perhaps inevitable that some permanent layoffs will follow the enforcement of this or any minimum wage law, for there are bound to be industries which find it impossible to pay the minimum wage. There is also the possibility that the enforced higher wages will bring about the invention of labor-saving devices which will lead enterprisers to employ more machinery and fewer workers. On the other hand, the minimum wage will unquestionably strengthen the hand of socially-minded employers who, though anxious to pay their workers a fair wage, have been unable to do so because of the cut-throat competition of "chiseling" enterprisers in the same lines of production.

Wartime and Post-War Labor Problems

In mechanized warfare, the workers who man the machinery of production are quite as necessary as the fighters who man the tanks, ships, and planes that engage in combat. Their work is less exciting, less dangerous, and better paid than service in the army, navy, and air force; but the deferred ratings given in World War II to workers in certain occupations is ample recognition of the essential part played by industrial workers. The basic principle of sound business management—to employ every worker in such a way that his ability will be utilized to the fullest—is equally good practice for a nation at war. Manpower is always important when there is work to be done, but it is doubly important in wartime. The failure to make full use of the available human resources weakens a country's war effort, and may prove very costly by delaying the day of victory.

Labor Shortage and the War Manpower Commission. In April, 1942, President Roosevelt created the War Manpower Commission "to establish basic national policies to assure the most effective mobilization and maximum utilization of the nation's manpower in the prosecution of the war." On December 6, 1942, an Executive Order gave the Chairman of this Commission almost dictatorial authority over the people of this country. The Commission was empowered to decide who should work, where, and at what task, and whether he should or should not serve in the armed forces. The Selective Service System was placed under the War Manpower Commission, which was given the duty of providing men for the armed forces through the System, was made responsible for training workers for vital industries, and had other important functions to perform.

The necessity for centralization of direction in the utilization of manpower, and the substitution of compulsory for voluntary compliance with directives, arose with the growing acuteness of the labor shortage problem in many parts of the country. Among the specific causes of the faulty utilization of American labor were the following: "(1) workers changing jobs for higher pay; (2) employers failing to use workers effectively; (3) inadequate housing and transportation facilities, causing large turnover of workers; (4) employer prejudices in hiring workers; (5) labor piracy; (6) lack of comprehensive training programs to supply vitally needed types of skilled and unskilled labor; and (7) over-concentration of war contracts."

By classifying occupations as "non-essential" or "essential" (and as "non-deferable" or "deferable" in their relation to active military service), by encouraging workers to shift from the former to the latter type of jobs, by specifying the conditions under which a worker might move from one job to another, and in other ways, the War Manpower Commission undertook to utilize the labor force of the country for expediting the prosecution of the war. The manpower problem was not confined to the production of war equipment but was apparent in nearly every branch of economic activity. It was especially serious in agriculture, from which large numbers of men had been drawn into combat service and "essential industries." The threat of a crippling shortage of farm labor emphasized the highly essential nature of agriculture in time of war—especially in a war in which we had to feed not only our armed forces and civilians, but also, to a considerable extent, the people of all the United Nations.

Labor Relations in Wartime. Doubtless the thought uppermost in the minds of American employers and employees during World War II was the necessity of winning the war. There is no reason to question the patriotism of either of these groups, and it seems fair to say that enterprisers and workers alike stood ready to make whatever sacrifices were required to bring victory to the Allies. But probably very few individuals were anxious to make greater personal sacrifices than were necessary, and fewer still were willing to deny themselves comforts while others were indulging in unwonted luxuries. Carrying on war production under conditions which approximate freedom of enterprise is almost certain to lead to confusion and misunderstanding, because some individuals seem to gain at the expense of others or of society as a whole. An increase in demand without a corresponding increase in supply brings excessively large war profits to certain business concerns and excessively high wages to some classes of workers. Employers are appalled at the cupidity of the relatively few workers whose bargaining position in time of war enables them to double their wages, and workers are equally astounded when they hear of occasional profits so huge that large bonuses are given to even minor executives in order to avoid the payment of high excess profit taxes.

War does not alter the general nature of labor's objectives. In wartime as in time of peace, workers are interested in getting high wages, short hours, and satisfactory working conditions. World War

II brought higher hourly rates, and larger weekly incomes, in many industries. This was particularly true, of course, of shipbuilding, machine-tool manufacture, and other war industries, in which the government paid the bill for the products, and *paid well* to induce speedy delivery. Employers in ordinary industries were often compelled to raise wages in order to hold their labor force. However, wage increases did not always keep pace with the cost of living, so that the real wages of some workers showed a decline during the war period. Hours of labor, too, increased somewhat but without serious protest from the workers, since premiums were usually paid for work in excess of 40 hours a week.

Wartime Industrial Strikes. The desire of workers or employers to gain advantages which were not willingly granted is indicated by the strikes that occurred in the period of accelerated war production. Organized workers were not slow to demand wage increases which they said were warranted by the increased cost of living and could readily be paid from the substantial profits being reaped by their employers. Some employers, on the other hand, did not hesitate to charge that the workers were using the war situation to get higher wages, with the implication that a lack of patriotism was involved. This implication was no more applicable to workers than to those employers who took advantage of the same war situation to increase their profits. Of course, neither group was responsible for bringing about the conditions that made high wages and large profits possible. The truth is that both high wages and large profits arise almost inevitably out of a state of war, and this condition is certainly not chargeable to either labor or business enterprise. However, the workers' gains do not necessarily come without a struggle. Wartime competition among employers who need scarce labor may lead to voluntary grants of wage increases and other concessions, but the war-production strike record given in Table 1 shows that industrial conflict does not declare a truce in wartime.

These figures may be compared with the ten-year average for 1930–39, which show in that decade an annual average of 2017 strikes, with 911,575 workers involved, and 14,262,700 man-days idle. (In World War I there was an annual average of about 3000 strikes during the seven-year war and post-war period.)

The National War Labor Board. Idle manpower is bad enough at any time, since the failure to make full use of human resources results in a smaller national income than would be available if all

TABLE 1. STRIKES IN THE UNITED STATES, 1939–45[a]

Year	Number of Strikes	Workers Involved	Man-Days Idle
1939	2613	1,170,962	17,812,219
1940	2508	576,988	6,700,872
1941	4288	2,362,620	23,047,556
1942	3060	707,000	4,475,000
1943	3072	1,981,279	13,500,529
1944	4956	2,116,000	8,721,000
1945	4750	3,467,000	38,025,000

[a] Source United States Bureau of Labor Statistics.

labor were at work. But idle manpower in wartime may bring national disaster by limiting the quantity of war materials for the fighting forces or goods essential to the continued health and strength of civilians.

The urgency of attaining maximum wartime production and the increasing seriousness of strikes led to the introduction into Congress of several anti-strike bills, but this proposed legislation was rejected, for a time, in the hope of finding voluntary means for settling industrial disputes and thus preventing interference with production. In March, 1941, President Roosevelt established the Defense Mediation Board, whose task was to hold hearings on industrial conflicts that failed to yield to employer-employee negotiations of the usual type. The Board functioned with moderate success, but its usefulness ended with the so-called Captive Mine Case in which, by a nine-to-two vote, the Board rejected the demand of the United Mine Workers of America for a closed shop. The C.I.O. members of the Board promptly resigned, and a strike was called. John L. Lewis, president of the union, finally agreed to arbitrate the dispute, but only after three requests had been made by President Roosevelt and with full knowledge that the third member of this board of arbitration would be a man who favored the union demand. The Board promptly voted to grant the union the closed shop.

The attack upon Pearl Harbor and the immediate declaration of war by the United States brought the strike problem to a head and emphasized the necessity of finding a solution. On December 17, 1941, President Roosevelt called a conference of representatives of labor and industry, at which it was agreed that for the duration of the war there would be no strikes or lockouts; that all labor disputes

would be settled by peaceful means, and that a National War Labor Board should be established for the peaceful adjustment of such disputes. President Roosevelt created this Board by Executive Order on January 12, 1942, "for the purpose of adjusting and settling labor disputes which might interrupt work which contributes to the effective prosecution of the war." The National War Labor Board consisted of four public members, four employer members, and four labor members (two representing the A.F. of L. and two the C.I.O.). Regional War Labor Boards were set up, and disputes between employers and workers were heard by tripartite panels consisting of one representative each from industry, labor, and the public. Recommendations by these panels were made to the Regional Boards, which then rendered decisions that became effective except in cases in which appeals were taken to the National War Labor Board. There can be no question that the work of the War Labor Board did much to reduce friction in the field of labor disputes, and thus aided in keeping production at a high level of efficiency.

Anti-Strike Legislation. The National War Labor Board had an advantage over the Defense Mediation Board in starting out with a definite agreement by labor and industry to outlaw strikes and lockouts temporarily. Though this agreement did not wholly prevent strikes, as we have seen in Table 1, the number and seriousness of work stoppages were materially reduced. However, the fact that there were some actual strikes and threats of others in important fields of production (notably in the mining of coal) led Congress to pass, on June 25, 1943, over the President's veto, the Smith-Connally Bill, which is known also as the War Labor Disputes Act. This Act related to establishments "which may be required for the war effort or which may be useful in connection therewith." It authorized government seizure of private plants in which production had been interrupted by strikes, and provided (1) for maintaining the same working conditions as prevailed prior to governmental possession, and (2) for penalties against persons instigating or aiding any strike, slow-down, or interruption in plants taken over by the government. It also required that thirty days' notice of a labor dispute must be given, and that after the expiration of this waiting period a secret strike ballot should be conducted by the National Labor Relations Board for the purpose of determining whether a majority of the workers favored going on strike.

This anti-strike bill was, from the time of its enactment, severely

criticized by labor, by impartial students of labor problems, and by a good many business men, as being unlikely to improve the situation. It was regarded by many observers as being incapable of effective enforcement, and was charged with encouraging rather than discouraging strike sentiment among groups of workers who might be seeking relief from what, rightly or wrongly, they regarded as more than their fair share of the economic burdens of the war. It was, said *The New York Times* editorially, "one of the stupidest pieces of legislation ever passed by Congress." [17]

The end of fighting in World War II, as in World War I, brought a great increase in the number and seriousness of industrial strikes in this country. In the last full year of the war, 1944, less than one-tenth of one per cent of the "total available working time" was lost through strikes. In 1945, the loss was four times as great. Once the task became one of reconversion rather than maximum war production, organized labor proceeded to take measures to safeguard the wage gains that had been made during the war. Demands for increases in wage *rates* were made, with the general objective that the "take-home pay" for a 48-hour week (which included eight hours at overtime rates) should continue to be paid for the "normal" 40-hour week. Strike after strike was declared, and in general settled by granting wage increases, though usually the increases were not much larger than one-half of the amounts demanded. Congress, anxious to have the country converted speedily to peacetime industry, threatened the strikers with a new anti-strike law (the Case Bill), which rejected President Truman's proposal to establish a fact-finding commission to investigate the merits of a given union demand, and called for the prohibition of mass picketing, and the revision or nullification of the Norris-La Guardia Anti-Injunction Act and the National Labor Relations Act. The Case Bill was vetoed by the President.

American experience seems to indicate that there is little reason to suppose that anti-strike legislation is the remedy for industrial disputes, or that it can actually be enforced. Indeed, there seems to be a growing feeling among labor experts that industrial conflicts must in general be settled by collective bargaining rather than through legislation or governmental intervention. One of our well-known economists, Professor Slichter of Harvard, goes so far as to

[17] *The New York Times,* February 28, 1945.

suggest that "an occasional strike or lockout is needed both to test the willingness of each side to fight and to keep alive a vigorous spirit of realism." [18]

Prospects for Industrial Peace

In our discussion of employer attitudes toward unionism, we noted that not all American business men are opposed to collective bargaining. There are many, indeed, who would far rather deal with a strong union than with the workers individually; and there are certain socially-minded employers who for years have been earnestly seeking a remedy for industrial conflict. Though conflict seems to be inherent in our type of economic system, means have been found for alleviating the situation to some extent.

Mediation and Arbitration. It is possible, at times, to avoid open breaks between employers and employees through the use of mediation or arbitration. Mediation (or conciliation) is a device for smoothing out the process of collective bargaining. The mediator is a disinterested third party who meets with the disputants and attempts to bring them to satisfactory terms. He isolates the main issues from the non-essentials, and by creating an atmosphere of friendliness and confidence aids the contending parties to reach an agreement, though he does not himself render a decision. Mediation, then, consists of talking over differences in the presence of a neutral party (sometimes called an "impartial chairman") who, by means of tactful questions and suggestions, but not by argument, eases the situation and in many cases gets both parties to make concessions so that a peaceful settlement can be reached.

In its Conciliation Service, the United States Department of Labor has several scores of "commissioners" whose services are available when both sides to an industrial dispute request their assistance in ironing out differences. According to the President's Annual Message to Congress on January 21, 1946, the Conciliation Service had handled, in the preceding five months, "over 3000 disputes affecting over 1,300,000 workers, without a strike threat" and had "assisted in settling about 1300 disputes where strikes were threatened which involved 500,000. . . . Many of these adjustments occurred in key industries and would have seemed to us major crises if they had not

[18] Quoted in *Information Service*, New York, Federal Council of the Churches of Christ in America, January 19, 1946.

been settled peaceably." The successful functioning of this agency suggests the desirability of enlarging this Service so that its good offices may be made available on a larger scale in the future.

When arbitration is resorted to, it is assumed that a decision will be rendered by the arbitrator (or board of arbitrators). A hearing is held, at which the parties to the dispute have a chance to present their cases, and on the basis of the evidence presented the arbitrator, or arbitration board, makes what is presumably a thoroughly impartial judgment. In many instances, the disputants agree beforehand to accept whatever decision is rendered, but in some cases it is agreed that the parties concerned shall be free to accept or reject the award.

Mediation and arbitration are valuable in providing a period of calm deliberation before a strike or lockout is declared. However, the agreement reached is more likely to reflect the bargaining power of the two parties than to be based on any principles of "fairness" or "justice." An arbitrator, trying to please both contestants, usually comes to a decision that represents a compromise, giving to each party somewhat less in the way of advantage than has been asked for. Thus a truce is patched up and weapons are laid aside temporarily, but the conflict is fairly certain to be resumed whenever a shift in bargaining strength gives promise to one or other of the parties that gains may be realized through a display or exercise of power. Despite the temporary nature of most settlements, mediation and arbitration serve a useful purpose in reducing the number of disputes that reach the strike stage—often by enabling both sides to "save face" when they have taken definite stands and are too stubborn to back down. They are less costly than recourse to militant measures, and are therefore preferable to the strike as means of effecting the economic readjustments that must be made from time to time.

The Outlawry of Strikes. The question of whether workers should ever be allowed to go on strike is sometimes raised. The strike often brings inconvenience and hardship to employers, employees, and the public. Like military warfare, it does not decide the right or wrong of an issue, but merely determines which side, for the moment, is the stronger. Hence the strike, like the lockout, is socially objectionable. Nevertheless, "a strike may be less harmful to the state and to industry than peace maintained either by statutory tyranny, legal usurpation, or overwhelming economic domina-

tion." [19] To outlaw the strike would weaken the workers' bargaining power greatly, since, in the last analysis, this power rests upon the ability to damage the employer's business interests by waging a strike.[20]

The prohibition of strikes might be justified in the so-called "essential industries" which must be operated continuously if the public welfare is to be preserved. It would seem best, in the case of such industries, to take them entirely out of the field of private enterprise, and to serve notice that in these particular industries strikes will not be tolerated. So long as an industry is in the hands of private enterprisers, being operated for the profit of its owners, it would be obviously unfair to hamper labor in its profit-seeking activities by abolishing the right to strike in that industry. A further problem that would have to be solved is that of determining which industries are to be regarded as essential. Probably most persons would agree that the mining of coal and the operation of communication and transportation lines are vital to the welfare of the public. But may not the production and distribution of milk, bread, and other forms of foodstuff be equally essential? Indeed, a move to abolish industrial strikes on the basis outlined above might easily lead to the public ownership of many types of industry.

Peace Through Conference. Employee representation, as we have already noted, has for its outstanding feature a system of frequent conferences between chosen representatives of the employer and his employees. It "aims to provide government by consent of the governed. It is built upon the assumption that free discussion between management and workers will bring about a better understanding of the problems to be solved, create a spirit of genuine cooperation, call forth helpful suggestions from intelligent workers, and permit the settlement of differences by negotiation instead of combat." [21] There are few who would challenge the assertion that industrial peace can be promoted through friendly conferences which keep the employer and employee informed of each other's

[19] Solomon Blum, *Labor Economics,* New York, Henry Holt & Company, Inc., 1925, p. 268.

[20] In printed pamphlets and full-page newspaper advertisements, the National Association of Manufacturers in 1946 presented "a national labor policy to minimize industrial strikes," which included the prohibition of strikes, lockouts, and boycotts. Organized labor, however, manifested no inclination to surrender the right to strike, its most powerful bargaining weapon.

[21] Paul F. Gemmill, *Present-Day Labor Relations,* p. 58.

problems and aspirations. There are many who question that the conference plan can be wholly successful in this respect, so long as it is based upon the company union, which so many workers regard with suspicion.

But this particular handicap to employer-employee conferences can be avoided through the adoption of what is popularly known as "union-management cooperation." [22] Under this plan of organization the workers belong to independent unions, not company unions, and consequently have behind them the power of collective bargaining that goes with effective unionization. Thus, they are not dependent upon the benevolence of the employer, but are able to fight their own battles in the writing and enforcement of a trade agreement. But union-management cooperation provides also for frequent meetings between the representatives of management and workers *in a given plant,* and these meetings have proved extremely helpful in the solution of local problems. The signal success which has attended the operation of union-management cooperation in the case of the Baltimore and Ohio Railroad has led to its installation in other establishments in this country and Canada.

Conclusion. In a society which endorses free enterprise and competition, and measures success by the individual's ability to acquire material wealth, it is difficult to see how industrial conflict can be eliminated, since every incentive is in the direction of getting for oneself all that one can. "It is an indisputable fact," wrote the late Ramsay MacDonald, "that the wage earner and the wage payer have interests which are antagonistic and in the nature of things cannot be reconciled."

It appears that the most that can be done, under existing conditions, is to make the best of a bad situation. If industrial conflict cannot be avoided in a competitive economic order, we can at least provide "an open field and a fair fight," and seek, at the same time, to safeguard the interests of the public. There can be no "fair fight" without the development of a unionism strong enough to win the respect of employers and to enforce collective bargaining. The absence of such a degree of strength would mean economic serfdom. To maintain a strong bargaining position involves adherence to the principle of the closed *shop,* but the closed *union* should be opposed. Mediation and arbitration are preferable to the strike, even though

[22] *Ibid.,* chap. 9.

they may end in compromise and in decisions which hold good only until a new agreement is drawn up. But it seems reasonable that the strike should be forbidden only in those industries that are sufficiently essential to the public welfare to justify their socialization.

It is entirely possible that there would be no problem of industrial conflict in a socialist or communist state. But to many Americans a cure of this kind would doubtless appear to be worse than the disease itself.

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1. It is held by some that the interests of employer and employee are identical, and by others that these interests are antagonistic. What is the truth in the matter?
2. Speaking not as an employer or employee but as a member of society, state your reasons for favoring or opposing collective bargaining.
3. Compare the number of American workers under "employee representation" with the number belonging to unions which are independent of employer control.
4. What are the relative merits of "craft" and "industrial" unionism under present-day economic conditions?
5. Compare or contrast the American Federation of Labor and the Congress of Industrial Organizations.
6. Employers' associations are sometimes said to parallel the national unions. Explain why you think the suggestion of parallelism is or is not sound.
7. Why do labor organizations regard "recognition of the union" as vitally important to their interests?
8. Unionists insist upon applying the principle of "standardization" to wages, hours, and working conditions, in drawing up their trade agreements. Why do they regard this principle as important?
9. What are the purposes and methods of sabotage?
10. In what respect does the closed union resemble the industrial monopoly?
11. "It is the open union operating under the closed-shop principle that most students of labor regard as the best form of labor organization yet devised." In what respects is this combination superior to (a) the open union and the open shop, and (b) the closed union and the closed shop?
12. Explain the way in which a successful union tends to get for its members the favorable wages, hours, and working conditions which "would tend to come to these workers *in the long run* and *under competitive conditions* even in the absence of a union organization."
13. Discuss the methods of limiting output which are sometimes practiced by organized workers.

14. Cite instances in which enterprisers also are guilty of restricting production.
15. The strike and the lockout are said to be "similar in purpose, in method, and in social consequences." Examine this statement critically.
16. On what basis has the closed shop been attacked by those who have conducted the "open-shop movement"?
17. Describe the essential features of the company union.
18. Why are unionists so violently opposed to "yellow-dog" contracts and to the use of judicial injunctions in labor disputes? What threat do such contracts and injunctions hold for independent unions?
19. Discuss the purpose of the National Labor Relations Act, and the functions of the National Labor Relations Board.
20. State the main provisions of the Fair Labor Standards Act, and the need for such legislation.
21. Discuss the attitude of workers and employers toward the question of high wages and large profits, respectively, in time of war.
22. During World War II we set up special agencies to handle disputes between employers and workers. Explain the need for such agencies.
23. How was the problem of strikes dealt with in World War II?
24. Discuss the need for, and usefulness of, the National War Labor Board.
25. What are the probabilities of securing industrial peace, and desirable employer-employee relations, through anti-strike legislation?
26. Distinguish between mediation and arbitration.
27. If industrial strikes were outlawed, the public would be spared a great deal of inconvenience and even hardship. Why, then, should we hesitate to prohibit the use of the strike?
28. The unionists who are antagonistic to "employee representation" are usually kindly disposed toward "union-management cooperation." Why?
29. "The class conflict between an owning and a working group is not only a logical thing to expect but a fact which has unquestionably been found in history," says Norman Thomas. Is there, then, any solution of the problem of industrial conflict?

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4. *Wages and Population*

society in which practically all commodities and services are mic goods" and not "free goods," the question of purchasing of paramount importance. Between riches and poverty great gulf fixed—the rich have much purchasing power, ually none. Those who have much may, like Dives, fare every day, but those who have none get only the fall from the rich man's table. The purchasing power industrial workers comes almost wholly in the form of largely on this account that labor seeks always to raise l clings tenaciously to wage levels already attained when- uctions are threatened. For the laborer is no less anxious e business enterpriser to have what he considers the "good s" of life.

The Relation of Population to Wages. One of the most serious problems of labor is the prevalence of low wages among many classes of workers. Wages are paid for the use of labor, as a price is paid for any commodity, on the basis of scarcity. If, then, wages are low, the supply of labor must be relatively plentiful. This fact suggests the possibility of regulating wages by affecting the supply of labor through the control of population growth. It is this relationship between population and wages that leads to the problem of low wages, which we shall examine in the present chapter.

Per Capita Income. In Chapter 3 we touched upon the desirability of a country having a large total product, since it is from the total product that the owners of the productive agents must receive their pay. By a *large* product we mean, of course, one which, when divided among those who are to share in its distribution, provides large per capita incomes. The national income of the United States in the "good times" which prevailed in 1929 [1] was roughly $90,000,-

[1] We cite figures for 1929 because that year brought the people of the United States the largest national income they have ever enjoyed in time of peace. Whether we shall be able, without the stimulus of war, to duplicate the enormous output of 1945 (totaling approximately $150,000,000,000) remains to be seen.

000,000, or about $750 per capita. If, with this national income, our population had been only 90 millions instead of 120 millions, we should obviously have been better off economically since we should then have had a per capita income of $1000. If, on the other hand, our population had been 180 millions, the same total national income would have resulted in a per capita income of only $500. It is scarcely necessary to explain that a per capita income of (say) $750 does not mean that every man, woman, and child in the country actually receives this amount annually. Owing to the concentration of wealth and our method of distributing income, a relatively small number of Americans receive extremely large incomes; the vast majority have only enough to buy a satisfactory standard of living, and many are definitely poverty-stricken.

No country, then, can provide prosperity for its people if the population is so great or its national income so meager that its per capita income is small. Even a very large per capita income, as we have just noted, is no guaranty of *general* economic welfare, since per capita income is merely an average, in which may be concealed dizzy heights of individual prosperity and abysmal depths of individual poverty. In every capitalistic country we find wide differences in individual wages for personal services; in the United States, for example, wages range all the way from the thousand dollars or less a year received by pick-and-shovel men to the half million dollars or so paid to motion-picture stars or banking experts. These wage differences are, again, related to numbers. The number of day laborers is large in relation to the demand for their services, and as a consequence their wage is low; the number of capable actors and expert bankers is small in comparison with demand, and they are able on that account to command high wages.

General and Individual Wages. A statement to the effect that the general level of prices is high or low tells us nothing about a specific individual price that enters into the calculation of the price index number. In like manner, the existence of a high or low level of real wages within a country does not indicate how persons engaged in particular lines of work are faring. And just as we are more often interested in the price of a specified grade of bread, calico, or coal, than in general commodity prices, so when it comes to wages we pay more attention to the earning capacity of bakers, weavers, or miners than to per capita incomes. It is on his own wages, and not on per capita income, that the worker and his family must live. It is

individual real wages, therefore—the wages that they themselves receive—about which the workers are concerned; and these are the wages they have in mind when they insist on wage increases or resist wage cuts.

Population, the Supply of Labor, and Wages

The "Optimum Population." Labor is human energy expended for the purpose of acquiring income. It is definitely tied up, therefore, with the existence of human beings, and the quantity of labor is dependent chiefly upon the size of the population. The labor supply is affected, also, by the proportion of the population that is gainfully employed, the amount of time that the workers give to productive effort, and the intensity with which they work; but these are matters which, for considerable periods of time, are fixed by custom or even by union regulation. The amount of time expended in work and the intensity of effort being what they are, we may generalize to the extent of saying that a large population means a large quantity of labor available for use in productive enterprise. Whether the population is of a desirable size economically depends upon whether the land and capital with which the "gainfully employed" carry on work are adequate in both quantity and quality. From the economic point of view, the best or *optimum* population is that which results in the production of the greatest per capita output. It is large output per unit of population, and not per unit of land or capital, that makes for economic welfare. Some of the most productive land in the world is that which is cultivated very intensively by the people of China and India. But so much labor is lavished upon its cultivation that the product, though large per unit of land, is so small per unit of labor that those who farm it are seldom free from the threat of starvation. Since the goal of production is to provide human beings with commodities and services, production is (from the social point of view) most successfully carried on when per capita income is at its maximum, if only this income is distributed in a socially desirable way.

Labor of Specific Kinds. But we must consider specific kinds of labor, and not labor in general, if we are to understand the relationship between population and the supply of labor. It is obvious that wages in a given trade, say in plumbing, are affected not by the quantity of labor in general, but only, on the side of supply, by the number of plumbers in the market. Common laborers do not com-

pete with plumbers, plumbers with architects, or architects with lawyers, in seeking remunerative employment. It is the number of plumbers available, in relation to the demand for their services, that fixes wages in the plumbing trade. If plumbers are relatively plentiful, their eagerness to get jobs will lead them to bid against one another, and wages will be pulled down; if, on the other hand, plumbers are relatively scarce, the competitive bids for their services will have the effect of raising their wages.

Since labor is a perishable commodity which goes to waste unless it is used day by day, and since in most wage groups the workers cannot afford to indulge in the luxury of voluntary idleness, the amount of labor of a given kind that is offered for sale at any given time is ordinarily the total quantity in existence in the market in question. There are occasional exceptions, of course, as in the case of strikes, but it is safe to say that there is seldom much labor withheld from the market. This being true, the owner of labor (who is the worker himself) is frequently in the uncomfortable position of the owner of a perishable material commodity, such as strawberries or fresh fish—that is, he is obliged to take whatever he can get for his wares, for if in the absence of high bids he refuses to sell at a low price, his commodity perishes and he gets nothing at all for it.

Shifting Labor from Market to Market. If, over a considerable length of time, workers in a certain trade find it impossible to command a satisfactory wage, we might suppose that they would realize that their line of work was overcrowded and move off promptly to more lucrative fields. But this is more easily said than done. In "normal" times our bituminous coal mines are notoriously overmanned. If some of these laborers should give up mining and go into less crowded industries, this action not only would bring higher wages to those who moved but would relieve the situation for those who remained, and thus be beneficial to both. But where shall these mine laborers go in search of larger opportunities—where are the less crowded industries to which they could move? Here, indeed, is the crux of the problem, for it is difficult, if not impossible, to shift them about so that their lot will be improved. They might conceivably, with some slight training, become farm laborers, but there is usually an abundance of such workers, as is indicated by their low wages. The same is true of common labor in the steel industry, in construction work, and so on.

The truth of the matter is that common labor is ordinarily so plen-

tiful throughout industry in general that there is little to be gained by moving workers of this kind from place to place. The most that could be accomplished by this procedure would be to bring about an equalization of wages among common laborers throughout industry as a whole, and this process of equalization has been going on for so many years that it can probably be carried but little further. Moreover, any gain that some of the laborers made would be at the expense of others; a movement of laborers from mines to farms, for example, would pull down the wages of farm hands by increasing their numbers and thus changing the proportions of land, labor, and capital to the disadvantage of labor. Whatever might be done in the way of shifting common labor would result, therefore, in equalizing wages among the workers of this group; and any wage changes that might be made in this way would doubtless be very slight. It should be noted that changes that did occur would be the result of changing the supply of labor of this kind in the several markets affected, reducing it slightly at one point only to increase it at another.

Non-Competing Groups. But why should not workers, if they are dissatisfied with their present wages, change over to new occupations which are better paid? The answer is that a limited number of the more ambitious or more fortunate do manage to work their way from poorly paid jobs into positions that command high wages, but to the great majority the obstacles to such progress appear to be insuperable. The day laborer at $5 a day would like to be a carpenter at $12, but cannot afford to serve the long apprenticeship without which one is not permitted to follow carpentering. The chorus girl at $50 envies the prima donna her two thousand a week, but has neither the voice nor the personality demanded of a musical comedy star. The grade-school teacher at two thousand a year would like to be a high-school principal at five thousand, but lacks the education and executive ability essential for holding this position. As a consequence of lack of ability or lack of opportunity—and quite often the latter—there is surprisingly little competition for well-paid jobs on the part of those who are poorly paid.

Because of the tendency for workers to "stay put," once they get into a particular wage class, economists sometimes distinguish among certain broad divisions of wage earners, to which the name "non-competing groups" has been given. Though the classifications made by writers differ considerably, the following list will serve as

well as any to show that there is not a free movement of labor from grade to grade:

1. *Common Manual Laborers.* These are our hewers of wood, drawers of water, diggers of ditches, and other workers whose contribution to production lies chiefly in the expenditure of physical strength. They need no special training, and assume no responsibility in their daily work other than doing what they are told to do. Their annual wages, though always low, are highest in early life when they are strongest and most vigorous, and fall off rapidly after middle life is passed.
2. *Semi-Skilled Workers.* Here are found factory workers whose duties consist of tending semi-automatic machines, and also clerical workers filling routine jobs. In this group, moreover, belong such workers as taxicab drivers, whose duties demand an alert mind and the assumption of some responsibility. Sales people of ordinary ability may be included among the semi-skilled. The pay in this group of workers may be slightly higher than that of common labor, or it may at times be lower. But in either case, since the worker does not depend primarily upon physical strength for the performance of his task, he is able to carry on his work at a more advanced age than those in Group 1.
3. *Skilled Workers.* Both native ability and training play a part in this field of activity. Here we find machinists, plumbers, electricians, carpenters, and other skilled craftsmen; expert stenographers, bookkeepers, and other high-grade clerical workers; teachers in the elementary schools; and other types of workers whose tasks require some training and the assumption of considerable responsibility. The corner grocer, the barber, the owner of a shoe repair shop, and others who conduct small independent businesses may be included. Workers in this class ordinarily command comfortable, but not high, incomes.
4. *Professional Men and Business Managers.* Members of this group, in general, have incomes sufficiently large to buy high standards of living. Here are found physicians, lawyers, accountants, and technical experts of many kinds whose success hinges usually upon the possession of considerable

native ability, and professional training covering a period of years. High-grade salesmen, such as those who deal in insurance and securities, may well be included. Here, also, belong many of our business executives.

5. *"Captains of Industry."* This term is used in this connection to designate those who are outstanding figures in the economic world, and who, by reason of their unique abilities —that is, because of the absence of much competition—are able to command phenomenally high wages. In this class are the organizers and directors of "big business," our "wizards of finance," and business managers who are more than ordinarily successful. Here, moreover, because of their extraordinary scarcity, belong some of our famous stars of the stage and screen, champion pugilists, and an occasional lawyer, playwright, and novelist.

It is important to note that not only do the incomes in these several groups range from very low wages in Group 1 to astoundingly high wages in Group 5, but the incomes vary *inversely* with the

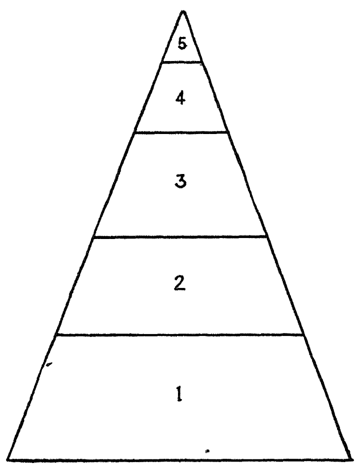

FIG. 1. NON-COMPETING WAGE GROUPS

numbers of workers in the groups. That is to say, the members of Group 1, the largest of the five classes, receive the smallest individual wages, while those in Group 5, the smallest group in the list, enjoy by far the largest individual wages. The situation is frequently

illustrated by use of a pyramid, as in Fig. 1, the size of the section given to each group indicating roughly the abundance or scarcity of workers in the group, and its height from the base line the position which its members occupy in the wage scale. This inverse relationship is not to be thought of as a mere coincidence. All that we know of wage determination leads to the conclusion that it is distinctly a cause-and-effect relationship. Wages are low in Group 1 *because* there are so many workers in relation to the number of jobs available for them; wages are high in Group 5 *because* its members are few in comparison with the demand for their services.

The existence of non-competing groups is believed to explain many of the differences in wages that may be observed on every hand. If all workers were alike, these differences in wages would promptly be wiped out by the force of competition. If any differences remained, and wages in some occupations were higher than in others, the extra pay would be merely compensation for the unpleasantness or riskiness of certain lines of work, and not the result of scarcity. But workers are not alike. They differ in native ability and training, as we have already said, and their differences prevent any considerable amount of competition between groups. It requires no argument to show that common manual laborers do not compete with great financiers. It is less clear, perhaps, that members of Group 1 are unlikely to bid for jobs wanted by those in Group 2; but in the main there is little competition between any two of the five groups. Occasionally, manual laborers may wander from Group 1, and, getting into Group 2 and being capable of doing semi-skilled work, bid against members of the second group, and thus bring down wages slightly; and semi-skilled workers from Group 2, having pursued a course of training, may elevate themselves into Group 3 and offer some competition to skilled workers there. But though this sort of thing may take place occasionally, it is safe to say that there is relatively little movement of workers from group to group. The difficulties to be overcome in climbing into a higher class are too great for any save the exceptional man.

Permanent Stratification of Groups. Moreover, there is a tendency for non-competing groups to be self-perpetuating. It would seem that parents, knowing from experience the inconvenience that goes with small incomes, would seek to get their children into the higher wage groups; or that the children themselves, trained in the stern school of poverty, would strike out for occupations more

gainful than those in which their parents served. But the odds, alas, are heavily against any such advancement, so far as most workers are concerned. It is possible, indeed, but not probable, that a boy will rise from his father's wage class into one paying a larger income. The difficulties may be those of heredity or environment, or both. We cannot be sure that the son will start life with greater native endowments than his father. But even if he does, there is the troublesome problem of securing training for the higher grade of work. He may, it is true, enjoy greater educational advantages than his father has had; but then, again, he may not.

What one does in the way of securing an education depends, probably more often than not, upon the environment in which one is placed. Environmental influences are scarcely calculated, in the low-wage groups, to spur one on to great deeds. The son of a manual laborer, even though he has in him the making of a skilled electrician, a great lawyer, or a merchant prince, is unlikely to receive encouragement from his immediate family and associates to set forth upon one of these careers. Indeed, it is probable that he will never learn of his inborn capacity for greater economic achievement; that he will, on the contrary, promptly get used to the standard of living of his father's wage class, and that, when he reaches man's estate, he will accept a job at "good wages" and continue to hold this job, or a similar one, throughout his working life. There is no way of knowing how much human talent goes to waste from lack of discovery or development, but there can be little doubt that the losses of this kind are enormous.

These are some of the hindrances to a free movement between the various wage groups which provide economic society with the productive agent that we call labor. Because there is no competition worth mentioning between these groups (though there may be a good deal of rivalry for jobs within a given group), wages may be high in one group and low in another, as we have already suggested. Whether they are high or low will depend upon the supply of and demand for labor of the various kinds. High wages are based on the scarcity of labor, and low wages on its abundance. For example, the success of members of Groups 4 and 5 in securing high incomes is due primarily to the limitation of numbers in these fortunate groups. If captains of industry were plentiful instead of scarce, they would receive much lower wages than at present; but, as we have explained, they are free from the competition of workers outside

their own group. So long as these various groups are separated one from another, with little opportunity for workers to move from group to group, we shall continue to have wage classes.

The Significance of "Proportionality." We see, therefore, that the quantity of labor is vastly important in the determination of wages. Low wages are the result of what is, for the workers, an unfortunate relationship in the quantities of land, labor, and capital. If labor should be reduced in quantity, land and capital remaining unchanged, or if land and capital should be made more plentiful without a corresponding increase in the quantity of labor, labor would become relatively more important and could claim and secure for itself a larger share of the product—that is, a larger wage. Practically all that has been said up to this point has been intended to emphasize the fact that wages are governed by the relationship between the quantity of labor, on the one hand, and the quantity of land and capital, on the other. If, then, low wages are to be raised, the remedy lies in making labor scarce or land and capital more plentiful. Since the workers can do but little in the way of bringing more land and capital into productive use, they might do well to concentrate upon the control of labor, with the thought of reducing the quantity available for productive enterprise, thus increasing the marginal productivity of labor and the price that is paid for its use. The quantity of labor may be controlled by regulating the birth rate or immigration, or both; and to a consideration of these methods of control we now turn our attention.

Wages and the Birth Rate

Population and Subsistence. "Populations tend to increase as aggregate wealth increases and tend to decline in numbers as standards of living rise," says the author of an important work on the theory of population.[2] The first half of this statement has long been understood, but the second is a development of modern times. Adam Smith, and even earlier English writers on economics, regarded a large population as the sign of a nation's material greatness, since they believed that the population of a nation was bound to expand with every growth in productive capacity. "The most decisive mark of the prosperity of any country is the increase in the number of inhabitants," wrote Adam Smith in his *Wealth of Nations* in 1776;

[2] Ezra Bowen, *An Hypothesis of Population Growth*, New York, Columbia University Press, 1931, p. 14.

and further, "Every species of animals naturally multiplies in proportion to the means of their subsistence and no species can ever multiply beyond it."

We have here the central idea of the Subsistence Theory of Wages, which for a time enjoyed wide popularity among economists. This theory recognized the fact that labor could be had only if provision were made for the maintenance of the laborers. This meant that the workers must receive, in exchange for their labor, a certain minimum of food, clothing, and shelter, in order to keep them alive and in condition to work. It was held, then, that wages tended to be fixed at that figure which would provide the worker with a bare subsistence for himself and his family. It was supposed that if wages were to rise so that they were more than adequate for maintenance at this very low level, the natural tendency for human beings to be fruitful and multiply would cause the worker to have more and more children. In this way, whatever gains might be made in wages would always be wiped out by the increased costs of supporting a larger family, and the standard of living—that of bare subsistence—would remain unchanged.

Population and Rising Standards of Living. From past experience, we have every reason to believe that populations do tend to increase as wealth increases, but not always at so rapid a pace. From 1800 to 1900, a period in which improved methods of agriculture and manufacture were flooding the world with commodities of all kinds, the population of Europe rose from 175,000,000 to 390,000,000. But this growth, great as it was, was not sufficient to keep up with the increased production of goods; and as a consequence the nineteenth century witnessed great improvements in the standards of living of the masses of workers. It is not inevitable, therefore, as the older economists believed, that wages should be held down to a subsistence level. Whenever increases in production outstrip increases in population, the per capita income rises and there is at least a possibility that the working classes will be able to command higher real wages than before. If every section of an economic society has shared in the population increase, and in exact proportion to its previous numbers, the larger total income resulting from improved production should provide higher real incomes for all. Of course, it would be still better, so far as standards of living are concerned, to have an increase in production while the population remained stationary. "If there had been no increase in population

during the last one hundred and fifty years," wrote Professor Ely early in the century, "the marginal productivity of labor would (if, nevertheless, modern methods of production had been developed) have been much higher than it is, and wages would have been correspondingly higher than they are."[3]

A little observation shows quite conclusively that many parents refuse to have families of such size as will hold them down to a subsistence standard of living. It can scarcely be regarded as pure chance that the families of the well-to-do are usually small, while those of the poor are usually large. Populations "tend to decline in numbers as standards of living rise," and there is today every indication that numbers are deliberately held down in order that high standards of living may be enjoyed. There is a limit to the number of children that can be well fed, well clothed, well housed, and well educated on a given income. An understanding of this fact, and a belief in quality rather than quantity, appear to be the only rational explanations of the small size of present-day families in the middle and upper classes. Population growth is governed by birth rates and death rates. The spread of sanitation and developments in the science of medicine have reduced the death rates materially in most countries during the past century, but birth rates have declined even more rapidly, largely, no doubt, because of the desire for better standards of living and the spread of information on family limitation. The result is that, though the total population is still increasing, the *rate of increase* is steadily declining. If we recall the fact that "average fecundity among modern, civilized women amounts to a total production of ten to twelve children, while the *actual* average number of children in families of western civilization is less than three,"[4] we shall need no further evidence that the birth rate is being regulated.

The Effect of Fewer Births upon Wages. In the practice of family limitation, or "voluntary parenthood," say the advocates of birth control, appears to lie a remedy for low wages. The plumber's wage is lower than that of the popular comedian, not because he renders a less useful service but simply because there are more good plumbers than good comedians, in relation to the demand for these two types of labor. It follows that plumbers could make themselves more fully

[3] Richard T. Ely, *Outlines of Economics*, New York, The Macmillan Company, 3rd ed., 1908, p. 436.

[4] Ezra Bowen, *An Hypothesis of Population Growth*, p. 177.

appreciated by reducing their numbers, and that, once the relationship between good plumbing and human welfare was properly understood, they could command higher wages for their labor. But to be effective, the reduction in numbers, instead of taking place among plumbers only, would have to be applied to Group 3 (of Fig. 1) as a whole, and not to just one type of skilled workers within that group. For if plumbers were made so scarce that their wages were abnormally high for members of Group 3, it is probable that other members of the group, or their sons, instead of following the trade of machinist, carpenter, or electrician, would go in for plumbing and thus provide the competition that would pull down the high wages that limited numbers had brought the plumbers. However, if all members of the group were to insist upon higher standards of living, the attainment of which involved having only one or two children instead of three or four, there can be little doubt that the effect of their decision would be felt in the next generation. For if the theory of noncompeting groups is sound, skilled workers would then be scarce, their marginal productivity would be high, and high wages would have to be paid to secure their services.

The attainment of high wages through the limitation of numbers is not so far-fetched as it might, at first thought, appear to be. Indeed, the chief obstacle at present is lack of knowledge on the part of those who would benefit most by the practice of family limitation. They are ignorant, first of all, of the vital part that numbers play in wage determination, and, in the second place, of satisfactory ways of limiting the size of their families to the number of children they can provide for adequately. But these are matters regarding which the general public is becoming better informed all the time and it is reasonable to suppose that the desire for higher standards of living—for more expensive automobiles, radio sets, fur coats, and the like—that is being built up by high-pressure advertising will gradually lead the workers to adopt the means necessary to the attainment of such standards—that is, the control of numbers. It seems improbable, however, that we shall arrive at the situation, described by a writer of a century ago, in which "more persons will rather dine alone on champagne and chickens than share their roast beef and pudding with a wife and family." [5] The desire for home life and the parental instinct will doubtless prevent the movement for high standards of living from being carried to such extremes. But

[5] Quoted in *ibid.*, p. 201.

it is entirely possible that workers may some day refuse to have more children than their wages will provide not only with "roast beef and pudding" and other creature comforts, but also with educational and cultural opportunities such as are now virtually unknown in our lower income groups.

Economic Consequences of Stationary and Decreasing Populations. The steadily declining rate of population increase, to which we have referred, will if continued bring us eventually to a point at which the birth rate is as low as the death rate, or even lower. We shall then have either a stationary or a decreasing population. Dr. L. I. Dublin, of the Metropolitan Life Insurance Company, in speaking of the situation in this country, says: "The continuation of the present tendency of rapid decline in the birth rate will in all probability result in bringing about a virtually stationary population in the United States by the year 1970. And at that time, under present immigration restrictions, the population of the United States will be approximately 150,000,000." Assuming that we may count on improvements in production continuing for an indefinite period, a stationary population in this country would facilitate the attainment of higher and still higher standards of living with the passage of time. Standards have risen in recent years because production has increased more rapidly than population. If population were stationary, the same increase in production would cause standards of living to rise more rapidly than in the past; and if, as some students of population problems think probable, we should eventually have a decreasing population, these standards would improve at a still faster rate.

Wages and Immigration

Immigration and American Wages. Population and the supply of labor are always influenced by birth rates and death rates, but they are sometimes affected by immigration as well. This is likely to be particularly true in the case of slightly developed countries with an abundance of natural resources. The United States during the past century is an excellent example. The increasing difficulties of making a living in Europe, and the apparently boundless opportunities offered here, drew millions to our shores. From 1820 to 1920, the population of the United States increased by almost 97,000,000 persons, and approximately one-third of this increase was by immigration. Has this influx of foreigners had any effect upon the

wages of American workers? There seems to be little doubt that it has. For their coming has added materially to the quantity of labor; and an increase in the quantity of labor, whether it results from births or from immigration, inevitably makes wages lower than they would have been if the supply of labor had remained unchanged. If it is true, as Professor Ely says, that the marginal productivity and wages of labor have been held down by the growth of population during the past century and a half, then it is equally true that native American wage earners have suffered from the flood of immigration from Europe to the United States. For some thirty or forty years our immigrants have been made up chiefly of laborers from southern and southeastern Europe who, by their competition for jobs, have doubtless done much to hold down the wages of common manual labor and semi-skilled workers in this country.

The Restriction of Immigration. In the forty-five-year period from 1900 to 1944, nearly 20 million immigrants were admitted to the United States. Table 2 shows the average number of immigrants for each of nine five-year periods. It will be noted that the

TABLE 2. IMMIGRATION TO THE UNITED STATES, 1900–1944[a]

(Annual averages for nine 5-year periods)

Five-Year Period	Annual Average Number of Immigrants for Period
1900–1904	651,024
1905–1909	989,446
1910–1914	1,034,940
1915–1919	234,536
1920–1924	554,520
1925–1929	304,182
1930–1934	85,390
1935–1939	54,485
1940–1944	40,718

[a] Source: Department of Labor, Immigration and Naturalization Service.

average for the ten years from 1905 to 1914, inclusive, was more than a millon a year. Naturally, the workers of this country did not ignore the fact that these additions to the labor supply in America were injurious to their economic interests. There were, as a consequence of the resentment engendered by the competition of these newcomers, many impassioned demands for the restriction of im-

migration; but it was not until 1921 that legislative measures were adopted limiting materially the number of immigrants that would be admitted annually into this country. The immigration law has since been changed several times, and as matters now stand, a total of only 150,000 immigrants is admitted to the United States each year from countries of the eastern hemisphere, on a quota basis that allots more than two-thirds of this total to England, Ireland, and Germany. Special concessions are made to natives of the western hemisphere, in that immigrants who were born in Canada, Mexico, Cuba, Haiti, the Canal Zone, and the independent countries of Central and South America, together with their wives and children under eighteen, are classified as "non-quota immigrants" and admitted without limit.

Since approximately 100,000 non-quota immigrants enter the United States annually in "normal" times, it might be supposed that immigrants to this country have totaled about 250,000 a year since the passage of this National Origins Act, which became effective in 1929. Table 2 shows that this has not been the case. The greatly reduced number of immigrants from 1930 to 1944 reflects not so much the limitations imposed by our current immigration barriers as (1) the unattractiveness of the United States (with its high cost of living, as compared with other countries) in years of depression, and (2) the restrictions placed upon *emigration* by some of the European governments.

Overpopulation and Migration. When a region becomes so densely populated that the standard of living is unbearably low, the more venturesome members of the group commonly go forth in search of economic opportunities that are not to be found at home. There is evidence that economic considerations have played a large part in practically all great migrations of the past. Certainly it cannot be doubted that the flood of Europeans to the United States during the past century—"the largest movement of immigrants into any country known to history"—was brought about chiefly by the desire to escape from the low standards of living of the Old World and share in the high standards of the New. The high real wages of the United States could not fail to attract the less favored wage earners of Europe. Hence, in the absence of immigration barriers, more than 35,000,000 Europeans migrated to the United States, and an overwhelming majority of these millions became a permanent part of our population and labor supply.

During the greater part of its existence as a nation, the United States has pursued the policy of encouraging immigration. America was to be the land of opportunity, the place of refuge for all oppressed peoples. But there comes a time in the affairs of nations when it seems wise to change policies. This time came, in the case of American immigration, when the workers of this country insisted upon having protection against the swarms of European competitors whose entrance into the United States imperiled "American standards of living." Our present policy is embodied in the National Origins Act, which we sketched briefly above.

The Case for Restriction of Immigration. There are some who question the justice of excluding from the advantages that we enjoy, the people of other nations who would like to share these advantages with us. It is often urged that we should continue to admit the overflow of population from crowded countries. But migration is not a genuine remedy for overpopulation. Italy provides an example of the futility of migration as a solution of the problem of overcrowding. As Benito Mussolini said repeatedly, while at the same time he was urging his people to have larger families, "Italy each year produces an excess of 500,000 men who must in one fashion or another emigrate." If it was necessary for this number to migrate every year, as Mussolini insisted, it is obvious that finding places for them elsewhere did nothing to raise the low standards of living that overpopulation had brought to Italy. All that this annual migration could do would be to prevent the situation in Italy from getting worse, and it would do this at the expense of the workers of those countries to which the emigrants went. This can scarcely be called a satisfactory solution of the problem of overpopulation; rather, it is what is popularly known as "passing the buck."

The true remedy for overpopulation, like charity, begins at home. Nations that do not want larger populations should not be expected to admit immigrants unless the country that seeks to dispose of its excess is earnestly trying to hold its birth rate down to a figure as low as its death rate. There are many who believe that the goal to be aimed at is the total exclusion of immigration from any country that has an increasing population. If one with a stationary or decreasing population wishes to raise standards of living by relieving the pressure of population upon its resources, it would appear to deserve help in placing some of its people elsewhere. But a nation that has not set its own house in order by controlling its birth rate

should be made to understand that it cannot dump its surplus numbers upon countries that have no need for them and do not want them. Labor, in its attempt to raise real wages by the exercise of family limitation, feels amply justified in demanding that its efforts shall not be frustrated by hordes of immigrant workers coming in from countries that give no heed to a proper adjustment between population and national resources. Migration is at best a temporary expedient for relieving overpopulation. It is upon the intelligent control of numbers that the world must depend for high per capita incomes; and it is to such control within particular income groups that workers must look for the attainment and maintenance of high wages.

Mobility of Labor and Commodities. Since we shall endorse free trade, or the unobstructed movement of goods between countries, when we discuss the tariff problem,[6] it may appear inconsistent to advocate the restriction of immigration in the present chapter. If tariff barriers are to be done away with, why not also remove all obstacles to migration? Is not the free flow of labor comparable to the free flow of goods? No, the two are not strictly comparable, at least not in their economic consequences. The removal of tariff barriers would lead to a readjustment of business based on geographical specialization, and business so adjusted would bring more commodities and services to the country formerly "protected," as well as to the countries whose goods had previously been shut out by tariff duties. But the removal of immigration barriers, unless accompanied by population control, would injure some nations by flooding them with millions of immigrants and yet bring no lasting benefit to the countries whence these people came. The admission of 500,000 Italian laborers annually to the United States would unquestionably pull down the wages of American workers but would not raise standards of living in Italy, since the places of the half million (if Mussolini's figures were correct) would be filled promptly by Italy's excess of births over deaths. It is quite possible, then, and without inconsistency, for a person interested in high wages for labor to approve of the free movement of goods and at the same time, in the absence of stationary or decreasing populations, to oppose the free movement of labor from country to country.

Another question that is sometimes asked in this connection is whether foreign labor does not compete just as severely when it

[6] In chap. 13.

stays at home as when it emigrates. For example, do not Italian workers in Italy, by making goods which sell in competition with American products, pull down the wages of American labor to as great an extent as though they came to the United States and competed directly? Again the answer is in the negative. Obviously, if a high protective tariff is in effect, the Italian goods and therefore the Italian labor will be unable to compete within the American domestic market. Even in the foreign markets from which goods are not artificially excluded, we find that American products made by highly paid labor can be and are sold at as low prices as the products of other countries made by poorly paid workers. Though American wages are high, the workers here, equipped with an abundant supply of land and capital of high quality, turn out goods so efficiently that the labor cost per unit is extremely low. Italian laborers working in Italy with limited quantities of poor equipment are much less productive than American workers, and do not affect the American wage scale; but if transferred to the United States and put to work here, they would offer direct competition to American labor and their presence would tend to pull down wages in this country.

If world-wide free trade were instituted while present immigration barriers were retained, the laborers of all nations would presumably be set to work making goods, in the production of which their respective countries enjoyed a relative advantage. Real wages would probably rise throughout the world, but differences in the wage levels of the various countries would not be wiped out. Wages then, as now, would depend upon the importance of labor in the productive process, and labor's importance, as measured by its marginal productivity, would in turn depend upon the quantity and quality of land, labor, and capital existing in a given country. If Italy and the United States should chance, under free trade, to compete in the manufacture and sale of a particular commodity, the productive advantages of this country would permit the payment of the prevailing high wage for American labor of the kind used and still allow the article to be sold at the same price as the Italian-made goods. If this were not the case, American labor would leave this particular industry, moving into other lines of work in which similar workers were enjoying better wages, and the industry in question would eventually disappear because of its inability to stand up in the face of Italian competition. We repeat, then, that it is

direct competition, and not indirect competition of the kind we have been discussing, that the highly paid wage earners of the United States must guard against.

Conclusion. We have seen that the size of the population plays an important part in the determination of wages through its influence upon the supply of labor in particular wage groups. Since labor is inextricably tied up with human beings, the supply of labor is practically fixed for short periods of time. In the long run, however, wages can be raised by reducing the supply of labor of a given type, if the demand for workers of this kind does not decline equally fast. Through the practice of family limitation, the low-wage groups could raise their real wages in the course of a generation, if at the same time they saw to it that immigration from other countries was stopped. The small families of the middle and upper classes are evidence of the prevalence of birth control. The high standards of living enjoyed by members of these classes indicate that restriction of numbers is rewarded with higher real wages. The solution of the problem of low wages, therefore, appears to many persons to lie in the refusal of parents to have so many children that their income will not provide a reasonably high standard of living for the family. But this remedy cannot readily be made available for those who need it most unless we abolish our legal taboos against instruction in scientific methods of family limitation. Since legislative restrictions of this kind interfere with the reduction or elimination of poverty, the removal of such restrictions is a goal toward which many socially-minded persons are working today.

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1. If we are to get an accurate impression of the social significance of wages, we must deal with *real annual* wages. Why would not *daily money* wages answer the purpose equally well?
2. The United States has 35 people to the square mile and a per capita wealth of $3000; Italy has 357 people to the square mile and a per capita wealth amounting to $833. Do you think it probable that low real wages in Italy and high real wages in the United States are in any way related to density of population and per capita wealth? Explain.
3. "The per capita income of the United States is $750. This means a total income of $3000 per year for the hypothetical family of four. This amount is sufficient to buy a good standard of living. Therefore, there is no problem of poverty in this country." Analyze this statement, and pass upon its soundness.

4. "Labor is a commodity, and the price paid for it, like the price of any other commodity, is determined by conditions of supply and demand." Criticize.
5. It is said that wages tend to equal the marginal productivity of labor; and yet a worker may receive different wages in two different years, even though he works just as hard in one year as in the other and turns out precisely the same number of units of product in each of the two years. Explain.
6. Define "optimum population."
7. What is meant by "non-competing wage groups"? How does the existence of such groups bring about differences in wages?
8. What are the factors that prevent a free movement between these so-called non-competing groups?
9. Why do these groups tend to remain *non-competing* even over long periods of time?
10. It is said that "proportionality" enters into the determination of wages. Explain the meaning of this term in this connection.
11. State the Subsistence Theory of Wages.
12. What evidence have we that the Subsistence Theory of Wages is unsound?
13. How are standards of living related to wages?
14. If it is true that wages are paid workers on the basis of their importance to society, how do you account for the fact that garbage collectors, whose services contribute greatly to the maintenance of public health in crowded communities, receive wages that are far lower than those of our comedians, who merely make us laugh?
15. Some years ago, Charlie Chaplin was offered $650,000 for a weekly radio broadcast of fifteen minutes over a period of twenty-six weeks. The offer, therefore, was at the rate of $100,000 per hour. Has a wage of this kind anything to do with marginal productivity? Does it bear any relation to population or the supply of labor? Explain.
16. What is Professor Ely's conclusion on the effect of population growth upon American wages during the past century and a half? How does he arrive at this conclusion?
17. What has the United States done to limit the admission of immigrants?
18. Explain how the restriction of immigration, used in connection with the practice of family limitation, is likely to affect wages.
19. Would you expect the effect to be immediate or long deferred in the case of (a) restriction of immigration, and (b) restriction of numbers by birth control?
20. How may a country solve the problem of overpopulation, if denied the privilege of sending its people to other countries?
21. Must not the advocate of free trade, to be consistent, champion also the abolition of immigration barriers?
22. Do English workers, when they remain in England, compete with Americans as seriously as though they came to the United States and found jobs here? Explain.

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5. *Economic Insecurity: Unemployment*

One of the distinctive features of modern economic life is the separation of the worker from ownership of the tools with which he performs his daily task. Business is owned and controlled by corporations, partnerships, and individual proprietors. Economic society is made up largely of employers and employees—those who provide jobs and those who fill them.

The Worker and His Job

The importance of a job to the industrial worker can scarcely be exaggerated. "Any one who has associated with those dependent upon daily toil for their living knows the positive terror in which thousands of men live as they think of the possible loss of their opportunities to work," [1] says one writer. Mr. Whiting Williams, who, in his studies of the workingman, has donned overalls and worked side by side with laborers in many industries, believes that "this insecurity of the job causes more antipathy to the whole industrial, social, economic, moral, and political structure than all other things put together." And Mr. Herbert Hoover, long before he became President, stated that "no waste is greater than unemployment, no suffering is keener or more fraught with despair than that due to inability to get jobs by those who wish to work."

The Significance of a Job. This emphasis upon the importance of an opportunity to work is fully justified by the situation. Among the minimum requirements of human beings are food, clothing, and shelter. Only in very primitive communities are all of these commodities made directly by those who consume them. What hap-

[1] Francis J. McConnell, in Kirby Page, editor, *A New Economic Order,* New York, Harcourt, Brace & Company, Inc., 1930, p. 348.

pens nowadays is that workers engage in highly specialized occupations, and in return for their contribution to production they receive purchasing power, usually in the form of money wages, with which they buy the commodities and services that they want most. But the dangers of the system are apparent. For human needs and human wants continue as long as life itself, but the ability of the worker to satisfy these needs and wants depends upon having a job. Hence, the loss of a job may spell tragedy. No job, no wage; no wage, no purchasing power; no purchasing power, no economic goods, is the inexorable sequence of negatives that causes workers to dread the day of unemployment.

The misery is multiplied, of course, when the loss of work falls upon the man who has a wife and children to support. Even a short period of unemployment frequently means a lowering of standards of living, and often to terribly low levels. Whatever savings may have been laid aside have to be managed with great economy. Reductions in expenditures are made all along the line. The food supply declines in both quantity and quality. The two or three quarts of milk are reduced to one, and such luxuries as fruits and fresh vegetables disappear from the menu. Often the parents deny themselves food they need badly, so that the children may not suffer from hunger. In the consumption of clothing and shelter, also, sacrifices are necessary. The children may have to go to school insufficiently clad, even to the extent of wearing soleless shoes in cold weather. Probably the family moves to smaller and cheaper living quarters in a less desirable part of town. Fuel, too costly to be wasted in heating the rooms, is in some instances used only for cooking the meager meals. These are only a few details of conditions following close upon the heels of unemployment, as reported by hundreds of social workers. Notwithstanding these economies, it usually takes many months for workers to get out of debt after business picks up again, and in some instances these obligations are never met. Studies of the effects of unemployment upon family life make gloomy reading.[2]

Unemployment: A Phase of Economic Insecurity. Unemployment is commonly defined as *involuntary idleness on the part of*

[2] True accounts of poverty resulting from unemployment that occurs even in the most prosperous of American "good times" may be found in Clinch Calkins, *Some Folks Won't Work,* New York, Harcourt, Brace & Company, Inc., 1930.

workers who are able and willing to engage in productive activities if given the chance to do so. Since, despite their desire for work and their attempts to find jobs, these would-be workers are unable to secure employment, their incomes are cut off, and they and their dependents suffer from the lack of commodities and services essential to their well-being. In our highly complicated economic society, the worker's ability to secure an income depends not only upon his skill and willingness to accept employment, but upon any of a host of conditions over which he as an individual has little or no control. He may be so lucky as to have steady work year in and year out, or, on the other hand, he may find himself dispossessed of his job and a victim of temporary or permanent unemployment. The economic maladjustments that result in enforced idleness, and consequent loss of income, constitute the problem of unemployment, which, in turn, is the most serious phase of the broader problem of economic insecurity.

The Nature and Extent of Unemployment

The average man who is hunting work probably does not know that there are several kinds of unemployment, and would not be interested in the fact if it were brought to his attention. To him the all-important question is how to find employment so that he may again enjoy an income. But to the student of labor problems, searching for a remedy for unemployment, an understanding of the types of unemployment and their causes is of first importance. We shall examine, in turn, "cyclical," "seasonal," and "technological" unemployment.

CYCLICAL UNEMPLOYMENT

The Business Cycle and Unemployment. The term "cyclical unemployment" is derived from the business cycle, with which unemployment of this type is associated. The words "business cycle" are simply a convenient expression for designating the wavelike fluctuations in business activity which most writers on economics describe as consisting of four phases—*prosperity, crisis, depression,* and *recovery*—and which are dealt with at some length in Chapter 12. Employment is plentiful in times of prosperity, it declines with the appearance of a crisis, it is scarce during the depression, but increases in volume with the recovery of business. The particularly serious stage of cyclical unemployment, then, is the period of busi-

ness depression. A survey of business conditions in the past reveals the fact that many of these periods of depression, which are commonly referred to as "hard times," have been experienced by all of the highly industrialized countries, for the business depression is no respecter of nations—it smites industry throughout the world, though some countries fare less badly than others.[3] Since the period of depression is a time of very limited production, business concerns reduce their operations or shut down their plants completely, many workers are laid off or forced to go on part time, and privation and suffering follow as a matter of course.

The Post-1929 Depression. The seriousness of the problem of cyclical unemployment in the United States cannot be stated in any very satisfactory terms. There have been some attempts to gather together figures showing the number of persons out of work, but the machinery available for the collection of data is woefully inadequate. No government census of unemployment was taken in this country between 1910 and 1930. The census of 1930 was the outcome of a popular demand for unemployment statistics for the period of business depression that followed the stock market crash of 1929. This census showed, according to the Secretary of Commerce, that there were 6,050,000 jobless workers in the United States by January, 1931, and that an additional 250,000 to 300,000 workers were idle "because of lay-off from their regular jobs at the time of the special census." [4]

In Table 3 are given figures on unemployment in the United States for the years 1929–44, inclusive. They indicate that even in the early years of the post-1929 depression as many as 3 to 7 million workers were unemployed, and that the number of involuntarily idle reached 14½ millions when the depression was at its worst in January, 1933. The table shows that, once the peak was passed, the volume of unemployment was smallest in September, 1937, but again became very serious in 1938 and remained serious until the demand for war supplies turned a labor surplus into a manpower shortage. It must be remembered that these figures are estimates and may not be wholly accurate, but they give some notion of the

[3] It may be noted that Soviet Russia claims to have vanquished business depressions and unemployment, which, according to the spokesmen for that socialist state, are inherent defects of capitalism. This point is touched upon in chap. 25.

[4] *American Labor Year Book, 1931,* New York, Rand School Press, 1931, p. 31

TABLE 3. ESTIMATED VOLUME OF UNEMPLOYMENT IN THE UNITED STATES, 1929–44

(Average monthly number unemployed) [5]

Year	Unemployed Workers	Year	Unemployed Workers
1929	429,000	1937	6,403,000
1930	2,896,000	*1937 (September)*	*4,479,000*
1931	7,037,000	1938	9,796,000
1932	11,385,000	1939	8,786,000
1933	11,842,000	1940	7,607,000
1933 (January)	*14,514,000*	1941	3,276,000
1934	9,761,000	1942	− 617,000 [5]
1935	9,092,000	1943	− 6,360,000 [5]
1936	7,386,000	1944	− 6,894,000 [5]

extent to which incomes, and consequently standards of living, may be affected by interference with business operations.

Unemployment in "Good" and "Normal" Years. In the early days of the depression, the Director of the Census estimated that we had in the United States between 47 million and 49 million "gainful workers." This did not mean that that number actually had jobs, but that these men, women, and children were able and willing to work, and therefore were members of the labor force of the country. If we place the number at 48 million, and accept the *average monthly* figure of 12 million unemployed in 1933, it is evident that about one-fourth of the nation's workers were deprived of the means of livelihood in that year.

However, the raids on income made by unemployment are not confined to years of depression. To be sure, they are most spectacular in such periods; but in times of "prosperity," also, there is a surprisingly large amount of involuntary idleness. It seems that unemployment, like the poor, we have always with us. Indeed, there is doubtless a causal relationship here, for certainly some, though by

[5] *The Economic Almanac, 1945–46,* New York, National Industrial Conference Board, 1945, pp. 38, 39. "Negative unemployment (as indicated for 1942, 1943, and 1944) arises during periods of high industrial activity when there are persons at work who are not ordinarily counted as members of the labor force." It will be clear that there may be some *unemployment* in a period of *negative unemployment,* as is demonstrated by the Social Security Board's statement that about a million persons were unemployed in June, 1944. It should be noted that the Conference Board's estimates of unemployment are lower than those of some organizations.

no means all, of our poverty is directly chargeable to the persistence of unemployment. The Social Security Board states that "in the years 1922–29, often cited as an example of prosperity in the United States, there was average unemployment of about 8 per cent [and] even under the abnormal pressure of all-out war, about a million persons were unemployed in June, 1944."[6]

The Severity of Cyclical Unemployment. Business depressions vary in their intensity, and it is customary to distinguish between "major" and "minor" depressions. Since the turn of the century we have had, in the United States, four major and three minor depressions, the major depressions falling in 1907–08, 1914–15, 1920–21, and 1929–38, and those of lesser importance in 1911, 1924, and 1927. Naturally, the greater the intensity of the depression, the larger the resultant army of unemployed. Professor Douglas has made some interesting estimates of unemployment in manufacturing, transportation, the building trades, and mining, which show that in these industries 16 per cent of the workers were unemployed in 1908, 9 per cent in 1911, 16.4 per cent in 1914, 23.1 per cent in 1921, and 12 per cent in 1924.[7] The greater severity of unemployment in the major depression years of 1908, 1914, and 1921 is evident. Not only is unemployment more serious in some years than others, but workers in certain occupations are particularly liable to be released from their jobs in time of depression. For example, Professor Douglas found that in one depression, 32.2 per cent of the workers in coal mining and 34.6 per cent in the building trades were deprived of their jobs, whereas in manufacturing and transportation the percentage was only 12.9.

The extent of cyclical unemployment in our great industrial centers may be illustrated by the case of Philadelphia. A study conducted by the Works Progress Administration showed that in 1933, the worst year of the post-1929 depression, only 34.1 per cent of Philadelphia's "employable persons" had full-time work, 19.9 per cent were on part time, and 46 per cent were wholly unemployed. Comparable figures for 1937 (with its greatly improved business conditions) were 70.5, 5.0, and 24.5 per cent, respectively, for the three categories of employment status given above.

[6] *9th Annual Report, 1944, of the Social Security Board,* Washington, Government Printing Office, 1944, p. 6.

[7] Paul H. Douglas and Aaron Director, *The Problem of Unemployment,* New York, The Macmillan Company, 1931, p. 32. Professor Douglas does not give the data for 1927 or for the post-1929 depression.

The seriousness of cyclical unemployment lies not only in the number of workers thrown out of employment, but also in the length of time they are compelled to go without work. Periods of depression last from a few months, in the case of minor disturbances, to as long as several years when the business disruptions are of greater proportions. The National Bureau of Economic Research estimates that the "downward swing" of the business cycle (including crisis and depression, both of which bring unemployment) has an *average* duration of some sixteen or seventeen months. Since the downward swing is often much shorter than this, it must of necessity be considerably longer at times. The point is important in connection with unemployment only in its implication that unfortunate workers may, through cyclical unemployment, be out of work not only for months but even for several years. Indeed, the post-1929 depression brought enforced idleness to some workers for as long a period as five or six years.

Short and Long Depressions. Perhaps a deep depression of short duration would cause less harm to workingmen and their families than a long-drawn-out period with a smaller percentage of workers unemployed. The former would throw many out of work for a short time, but the latter, through long-continued idleness for a smaller number, virtually overwhelms with misery those whom fate has chosen as victims. But industrial workers, like beggars, cannot be choosers. In their impotence to influence the business cycle they must take business depressions as they come. And it so happens that the depressions that cut deep, severing men by the millions from their jobs, are also those that seem to stretch out interminably, leaving behind them malnutrition, sickness, and discouragement for those least able to bear these ills, and a consequent resentment toward the existing economic and political order.

SEASONAL UNEMPLOYMENT

It is cyclical unemployment, with its millions pleading for jobs, with soup kitchens and bread lines and frantic appeals for relief funds, that most persons think of when the word "unemployment" is mentioned. But seasonal unemployment, though it commands less attention in the public press and is the subject of fewer discussions in the conventions of learned societies, is probably responsible for at least as much involuntary idleness as cyclical unemployment. The reason is that seasonal unemployment adds to its tally year in and year out, and not only in periods of business depression.

Production and Unemployment. Steady employment is dependent, of course, upon the continuous operation of business establishments. If production is interfered with, even for a short period, some employees are laid off or put on part time. Since seasonal unemployment goes hand in hand with declines in production, an examination of seasonal fluctuations in production gives a clue to the state of employment. If steady employment is closely related to continuous production, then any wide variations in production that take place in a period so short as to exclude an appreciable change in the quantity of labor available are strongly suggestive of seasonal unemployment. For if the number of workers in an industry is sufficiently large to run the industry when production is at its height, it would seem to follow that some of these employees must be jobless whenever production falls off—unless, as is most unlikely, they can readily find temporary jobs in other branches of industry.

Examples of Seasonal Industries. Among the industries that are notoriously seasonal in nature are the clothing and building trades and the mining of bituminous coal. "As Impartial Chairman in the Men's Clothing Industry in the City of New York during the past eight years," wrote Dr. Jacob Billikopf some years ago, "I have found that the men and women in the clothing industry, especially in the metropolis, have not averaged more than thirty-two weeks' employment in any year in the past decade, with the exception of the cutters, who constitute the most skilled element in the industry. The situation has been even more acute in the ladies' garment industry, about 80 per cent of which is located in and around New York City. In 1927, a highly prosperous year [in the clothing business, though one of mild depression for industry in general], the International Ladies' Garment Workers of America conducted a strike which lasted several months. One of the essential demands of the workers was a guarantee of thirty or thirty-two weeks' employment a year, which was denied." About 500,000 workers are engaged in making men's and women's clothing in this country. The manufacture of women's clothing is especially seasonal, with peaks in March and October, and valleys in January and July. Ordinarily, about three-fourths as many workers are busy in July as in March and October in the women's clothing industry.[8]

Employment conditions in building construction and bituminous

[8] W. S. Woytinsky, *Seasonal Variations in Employment in the United States*, Washington, Social Science Research Council, 1939, p. 49. This book presents much specific information on seasonal unemployment.

coal mining also are often very bad. A committee on seasonal operation in the construction industries, appointed by Mr. Hoover when he was Secretary of Commerce, reported that it is "the general rule that the building trades are occupied wholly for only three to five months in the year." Other investigations have shown that in many branches of the building trades the workers are employed only about 80 per cent of the year. The situation is particularly serious because there are about two million workers in the building trades who, as the result of the seasonal nature of the industry, find 50 per cent less employment in the poorest winter month than during the height of building activity in the summer. The production of bituminous coal is largest in November and smallest in April, with the output in the minimum month about three-fourths as great as that of the maximum. "From 1890 to 1932 the bituminous coal mines were open for operation an average of 205 days in a year; and the maximum year's employment in this four decades was 249 days in 1918, during the World War." [9]

Are All Industries Seasonal? We have cited several industries in which the seasonal fluctuations are very large. Though these are not typical examples, they are of particular significance because of the extent of the variations in production and the large number of workers affected in the months of slight business activity. But there is reason to believe that, on a smaller scale, practically all industries are seasonal. "It would be most difficult to find an industry which showed an even distribution of production and employment throughout the year," says Dr. Isador Lubin, an expert on labor problems. "An individual plant here and there, to be sure, may show steady and regular employment from month to month, but such plants are exceptions and by no means the rule in any industry. Some industries, like some plants, show less fluctuation in employment than others, but none are free from seasonal ups and downs."

Data compiled by the Research Division of the Federal Reserve System indicate that in the field of *manufacturing as a whole*, from 1919 to 1937, inclusive, there was a peak of activity in mid-September in which 3½ per cent more workers were employed than at the low point of activity in mid-January.[10] Professor Douglas figures that

[9] Mary L. Fleddérus and Mary van Kleeck, *Technology and Livelihood*, New York, Russell Sage Foundation, 1944, p. 55.

[10] W. S. Woytinsky, *Seasonal Variations in Employment in the United States*, p. 50.

seasonal fluctuations in manufacturing, transportation, the building trades, and mining cause on the average about 6 per cent of the workers in these industries to be unemployed. If other occupations (such as public utilities, merchandising, domestic and professional service, and government employment) were included, the estimate would have to come down somewhat, dropping perhaps as low as to 5 per cent. It is probably not far from correct, then, to say that on the average one-twentieth of our American workers are always out of work by reason of seasonal unemployment.

TECHNOLOGICAL UNEMPLOYMENT

The Problem of Permanent Layoffs. A third type of enforced idleness, to which Professor Sumner H. Slichter gave the name "technological unemployment," has been receiving a great deal of attention in recent years. The term is not wholly satisfactory, because, as Professor Slichter himself points out, it suggests only displacement by mechanical changes in industry, whereas the problem is in reality a much broader one—"the problem of unemployment produced by permanent layoffs."[11] A *permanent layoff* does not necessarily mean *permanent unemployment*, but it does mean that the concern for which a man has worked has no further use for him, at least not in his former capacity. Among the most important causes of permanent layoffs are improved technical processes, the extension of scientific management, industrial mergers, and important changes in demand on the part of the consuming public.

Labor-Saving Machinery. In dealing with employer-employee relations, we referred to labor's tendency to fight the introduction of labor-saving devices, owing to the fear that the new machinery would bring unemployment in the form of permanent layoffs. Despite this opposition, new processes are being brought into industry continually, and it is probable that there have been more revolutionary changes in manufacturing technology during the past quarter-century than in any equal period of time in history. One of these changes was the introduction of the automatic loom into textile manufacture, with the result that one worker can now take care of 24 to 64 looms, as compared with the one to eight looms previously handled. A second innovation was the cigarmaking machine, which

[11] Sumner H. Slichter, "The Problem of Technological Unemployment," in *Unemployment and Adult Education (A Symposium)*, New York, American Association for Adult Education, Inc., 1931, p. 34.

manufactures from 3000 to 4000 cigars in an eight-hour day, and threw out of employment over 30,000 skilled cigarmakers, each capable of producing only 300 cigars a day. Yet another technical improvement is the use of the "continuous process" in the manufacture of plate glass, which now turns the glass out in a continuous ribbon instead of in small cylinders which had to be cut and flattened. The new process means a reduction of 40 per cent in the amount of labor required.

These are examples of the mechanical changes that have taken place in scores of manufacturing industries which, according to Federal Reserve data, increased the *output per man* some 45 per cent between 1919 and 1929, and turned loose from their jobs some 500,000 workers, or about 6 per cent of the total number formerly engaged in manufacturing.[12] A similar movement has been going on in agriculture. The use of the most improved farm machinery, such as tractors and combines, brought an increase in agricultural product of 25 per cent *per worker* in this ten-year period. Though we are raising more farm products than ever before, we are doing it with fewer workers. The number of "gainful workers" in agriculture declined by almost two millions from 1910 to 1930, which probably means that these farm laborers, with their families, were forced by technological unemployment to seek their fortunes in the city.

The railroads, though handling more freight now than ever before, have laid off approximately a million workers since 1920. Switchmen and brakemen have been displaced by a mechanism for shifting and sorting cars, and 24,000 railway firemen were released through the installation of mechanical firing apparatus. Another great basic industry, coal mining, has also felt the pressure of mechanical progress. Eighty per cent of the bituminous coal produced in the United States is now mined by machinery—a fact which helps to explain why 110,000 miners lost their jobs in a recent decade. The post-1929 depression, with its labor surplus, did not provide much incentive for the introduction of labor-saving machinery, and it is too early to know how the technological advances of World War II will affect peacetime industry; but we may note in passing that the installation of dial systems and the merging of companies

[12] The Research Department of the International Brotherhood of Electrical Workers has compiled a list of forty-six important automatic machines that have done much to eliminate human labor from certain branches of industry. See *Annals of the American Academy of Political and Social Science,* March 1931, pp. 19, 20.

reduced the number of telephone operators by 40,000 between 1930 and 1940.

Improved Methods of Management. Some technological changes take place suddenly, rendering useless almost overnight the acquired skill that trained workers have built up over a long period of years. But permanent layoffs may also be produced by "small, non-revolutionary technical changes, by small improvements in management, by the gradual tightening of efficiency."[13] Scientific management, for example, is ever on the lookout for better methods of procedure, which in some cases make it possible to turn out the same amount, or even a larger amount, of product with fewer workers. Time and motion studies, which are devices of scientific management, tend ordinarily to split jobs into smaller and simpler parts. Some of these smaller operations are distinctly repetitive, and can be entrusted to the speedy, certain performance of machinery. Others are so simple as to require little or no skill on the part of the workers. A case in point is automobile manufacture, in which, according to Henry Ford, Sr., 43 per cent of the jobs can be learned in one day, and 36 per cent in one day to a week. The adoption of scientific methods may result, then, in the displacement of men by machines, and of highly skilled workers by those who can perform the tasks put to them with almost no training. In these and other ways, scientific management is in part responsible for technological unemployment.

Mergers and Unemployment. Business mergers or consolidations, which were once viewed with suspicion and apprehension in this country, take place so often nowadays that they no longer excite comment.[14] They, too, have helped to raise the total of technological unemployment by laying off employees who, by reason of the new arrangements, have been rendered superfluous. Many writers have called attention to the excessive productive capacity of most of our industries. One-sixth of our 1129 boot and shoe factories, if operated on full time, could produce our present output of footwear. The total output of cement and bituminous coal needed in this country could be produced by three-fifths of our cement mills and one-fourth of our coal mines. In some lines of industry this

[13] *Ibid.*, p. 34.

[14] From 1922 to 1928 there were 201 mergers effected, involving 1259 business concerns. See Stuart Chase, "The Iron Bouncer," in *Unemployment and Adult Education (A Symposium)*, p. 14.

overexpansion of plant is now in process of being eliminated through consolidations which will close down the less efficient units and thus effect large economies.

This elimination of waste in industry is highly desirable, from the point of view of both enterpriser and society in general, but it does add to the burden of technological unemployment. At the same time, however, it lessens somewhat the amount of seasonal unemployment. Mr. Sam A. Lewisohn says that "unemployment may be due to bad management which creates seasonal unemployment or good management which causes technological unemployment." Excessive productive capacity is wasteful, is the result of bad management, and brings seasonal unemployment. When mergers eliminate this waste they benefit society at large through the exercise of good management, but at the same time often increase the quantity of technological unemployment. Mergers may cause the displacement of factory workers, office employees, salesmen, and other types of labor. It is stated that the merger of the Colgate-Palmolive-Peet Company caused thousands of salesmen and office workers to lose their jobs.

The Effects of Permanent Shifts in Demand. Permanent layoffs are sometimes the result of permanent changes in demand. If the public refuses to buy a commodity, there is obviously no point in making it, and employers engaged in its manufacture are compelled to close down their plants. A striking example is the ship- and boatbuilding industry, which suffered a serious loss in demand following the close of World War I and as a consequence laid off some 337,000 men, but was revived by the pressing need for ships to replace those sunk early in World War II. Social customs and fashions bring about changes that are often the despair of business men. Presumably because of the almost universal use of the automobile, the demand for shoes has fallen off to an extent that has alarmed the manufacturers. Short skirts decrease the demand for dress goods, but react favorably on the sale of expensive hosiery. Bobbed hair destroys the market for hair nets, but provides an abundance of work for barbers. And so on. Professor Slichter believes that in at least twenty-three industries a major reason, and perhaps *the* major reason, for the shrinkage in employment has been the contraction of markets. Among the industries that have been injured in this way he lists shipbuilding, agricultural implements, the manufacture of carriages, wagons, horse blankets, fly nets, horseshoes, harnesses,

whips, buttons, pins, needles, hooks and eyes, hair pins, combs, jewelry, cigar boxes, and sewing machines.

Finding a New Job. We have spoken of unemployment of this kind as consisting of *permanent layoffs*, and have noted the fact that the workers who are laid off are not necessarily slated for *permanent unemployment*. Many of them, after remaining idle for some weeks or months, find new occupations in other industries. Some, and particularly those who are well along in years, may never again find steady work. But in any case they are probably permanently cut loose from the type of work to which they have been accustomed, unless they should be successful in supplanting other workers doing similar work in other plants, in which case it will be these ousted workers who suffer from permanent displacement. The worker who is laid off because of cyclical or seasonal fluctuations is likely to find his job again available with the return of "good times" or the seasonal "peak." But the victim of technological unemployment finds himself in a peculiarly tight place, from which he may be able to escape only by starting his working career all over again, with not only a new employer but a new occupation as well.

The New vs. the Old Job. It seems probable that in most instances the new job is not nearly so satisfactory as the old. Both mental and physical changes, and usually changes for the worse, are wrought by technological unemployment. The worker's confidence in his economic capacity is shaken, for the craftsmanship in which he placed reliance has been scrapped by the march of technical progress. His savings are consumed as, week after week, he looks for work, and he may have to ask for aid from relatives or even from charitable organizations or the public treasury. When he finally succeeds in getting a new job, it is fairly likely to represent a sacrifice in both self-esteem and income. For if, though formerly a skilled machinist, boilermaker, or woodworker, he must now accept employment as counterman in a lunchroom, gasoline station attendant, or night watchman, he can scarcely help feeling that he has lost caste, and his pay envelope will often supply concrete evidence that society regards his present occupation as less important than the work from which he has been ousted.

The Absorption of Laid-off Workers. Our economic system as a whole is able to absorb, to a large extent, the labor that is discarded by certain industries. New industries are continually springing up, and old ones gaining in importance. Automobile manufacture is

almost wholly the growth of forty years, and the commercial development of the radio has taken only two decades. Forty years ago the motion picture industry was a mere infant. Air conditioning and television are, of course, of still more recent origin. These newer lines of economic activity, and some of the older ones as well, have made great gains in the past decade or two, and not only have provided employment for a large part of the ever-increasing supply of labor, but also have given work to many men and women who have been displaced by mechanical inventions, scientific management, mergers, and changes in consumers' demands. Expansion in building construction between 1920 and 1940 drew 500,000 additional workers into the building trades; the increasing popularity of the automobile added some 700,000 new salesmen and garage workers, and 180,000 workers in filling stations; and the development of the hotel and restaurant business has given work to possibly a half-million men and women since 1920. Between 1930 and 1940, there was an increase of 176,000 miscellaneous sales people, 624,000 clerical workers, and nearly 600,000 chauffeurs, deliverymen, and similar workers.

United States census figures show that there was an addition of 7,209,000 to the total number of workers from 1920 to 1930 (and of 5,302,000 from 1930 to 1940). This does not mean, however, that there were seven million more persons *actually employed* in 1930 than in 1920, for the census officials include as gainful workers all "persons usually working at a gainful occupation," even though at the time of census-taking they may actually be out of work. There can be no question of the expansion of established businesses and the rise of new industries providing employment for large numbers of persons. But we cannot judge from our labor statistics whether developments such as these are capable of taking care not only of the raw recruits of our industrial army, but also of that large group of experienced workers (estimated at between two and two and one-half millions in the "normal" period 1920–27) to whom economic changes bring permanent layoffs. We shall again refer, later in the chapter, to the problem of placing workers who have been permanently laid off from their former occupations.

The Stabilization of Employment

The Inadequacy of Unemployment Data. Our inquiry into the nature and extent of unemployment has been hindered by the absence of full and complete statistics on the current volume of un-

employment and on changes in employment that have taken place throughout the country. When the data used have related to millions of workers, they have almost always been estimates and not exact reckonings; and when they have dealt with small numbers, we could not be certain that our "samples" were sufficiently large and diversified to be representative of the general situation. Nevertheless, the facts that are available indicate the seriousness of the problem of unemployment and the importance of finding a solution to it. To most students of the question it appears that one of the first moves toward a permanent solution must be in the direction of reducing the volume of unemployment through the stabilization of business.

Control of the Business Cycle.[15] In the case of cyclical unemployment, the achievement of stabilization is quite beyond the power of the individual enterpriser. It is true that business men could, if only they would, do something to bring about more stable business conditions by helping to prevent the "booms" of business activity which economists refer to as *periods of prosperity*. For, strange as it may seem, prosperity is the principal cause of depressions, and therefore of unemployment. In times of prosperity, with rising price levels, profits are large and business men wax expansive. "Manufacturers produce goods more rapidly than they are consumed. Merchants load their shelves with inventories. The increased demand for funds for business leads to increased interest rates, with the consequence that new enterprises, like the construction of new buildings, which are dependent upon an ample supply of funds at low rates, are postponed. There thus ensues a period of reduced business activity and reduced employment."[16] If, then, business men in general could be induced to hold their business in check when scientific statistical data indicate that the danger point is being reached, it might be possible to avoid great heights of prosperity and depths of depression, and thus avoid cyclical unemployment. But, since business is conducted for immediate profits, it seems highly improbable that many enterprisers would be willing to make the temporary sacrifice; and an attempt to stabilize business in this way would be fruitless unless it were carried on by a large number of business men. Not only is a single enterpriser powerless to affect the general situation, but if he should check his business in time of prosperity,

[15] The problem of the business cycle is dealt with in chap. 12.

[16] W. Randolph Burgess, of the Federal Reserve Bank of New York, in *Survey Graphic*, April, 1929, p. 23.

when others did not check theirs, he would himself suffer financial loss without appreciably delaying the coming of crisis and depression.

Private vs. Public Control. The inherent weakness of private methods of controlling business cycles has led many persons to endorse the public control of the price level, in the belief that the stabilization of purchasing power would result also in the stabilization of business activity, substituting for our violent cyclical changes in business a slow, steady expansion of industry that would increase production only as fast as was necessary to meet the needs of growth in population and permanently rising standards of living. The soundness of this theory has not yet been tested in actual practice. It appears likely, however, that if business depressions and cyclical unemployment are to be eliminated, it must be through public, rather than private, control of credit, investments, or profits—or perhaps even through government ownership and control of business. So long as the profit motive remains uncurbed, it is hard to imagine an economic society free from business depressions, with their heavy toll of cyclical unemployment.

The Murray-Patman Employment-Production Act. During the past ten years there has been much talk of the possibility of providing "full employment" for all who are able and willing to work, even though it should require large expenditures on the part of the federal government to make jobs available for those who would otherwise be unemployed. In Chapter 12 we shall examine in some detail the line of reasoning which seems to convince many that unemployment can be outlawed through governmental spending. At this point, we shall merely note the passage, in 1946, of the Murray-Patman Act, which President Truman called "the beginning of a fight for a healthy economy."

This Act declared it to be the government's responsibility (1) "to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining useful employment opportunities . . . for those able, willing and seeking to work," and (2) "to promote maximum employment, production, and purchasing power." Specifically, this new law authorizes the government to adopt an over-all national economic policy, and provides a moderate amount of machinery for translating this policy into action. The President, assisted by a Council of Economic Advisers, "will set national goals, review current economic trends and the effects upon employment of

government activities, and make recommendations for a full employment program." These recommendations will be transmitted to a joint congressional committee, and presumably will be given whatever consideration our national legislators deem appropriate. We shall not know for some time whether this recent piece of legislation will be of any assistance in reducing cyclical unemployment in this country.

The Reduction of Seasonal Fluctuations. In the case of seasonal unemployment, on the other hand, individual attempts to control the situation give greater promise of success than public action. The ideal arrangement, from the point of view of steady employment, would be a spread of production evenly over the twelve months of the year. But there are forces that interfere with a neat system such as this. In some instances—as in the growing of grains and fruits, the manufacture of raw sugar, and the canning of mackerel and salmon—it is the conditions of *supply*, and particularly the perishability of the good, that determine when production shall take place. But much more often production takes its cue from the conditions of *demand*, and experiences seasonal fluctuations because consumers insist on having large quantities of some kinds of goods at certain times of the year and will buy only small quantities at other times.

One careful student of the subject concludes that "the causes of seasonal slumps are, for the most part, climatic; certain commodities enjoy a naturally good sale in cold weather, others in warm." [17] Style, which is not wholly unrelated to weather conditions, plays an important part in some industries, and notably in the manufacture of clothing. The sale of toys and fireworks is naturally greatest just before Christmas and the Fourth of July, respectively. The lure of the outdoors and the bad radio reception often experienced in summer cause the sales of radio receiving sets to be six to eight times as great in the fall as in the spring months. Tradition sometimes affects the seasonality of a business; building construction, for example, though now carried on successfully in the winter, is still a business which has by far its greatest volume in mild weather. In all of these instances, however, it is the factor of demand that causes the industries to be seasonal.

Examples of Seasonal Stabilization. Since this is true in most instances of seasonal fluctuation, it is the consumers, rather than the

[17] Edwin S. Smith, *Reducing Seasonal Unemployment*, New York, McGraw-Hill Book Company, Inc., 1931, p. 54.

producers, who are responsible for the resultant seasonal unemployment. Occasionally the ultimate consumer can be induced by price reductions to buy at "off seasons" of the year, as, for example, in the case of anthracite coal, the price of which is lowered in the spring in order to stimulate sales. But the buying habits of consumers are hard to change, and though some concerns have been able to stabilize sales by price concessions and by advertising the year-round merits of their products, these are obviously schemes which are limited in their applicability. It appears that most persons "want what they want when they want it," and refuse to be inveigled into buying at times suggested by the manufacturer or merchant.

It follows, then, that whatever is to be done in the way of lessening seasonal unemployment must be done chiefly by producers and not by consumers, even though it is the spasmodic buying of the latter that causes the trouble. Some manufacturers have virtually eliminated unemployment by establishing equal monthly production quotas, urging wholesalers to buy somewhat in advance of actual needs (sometimes offering the inducement of price reductions, or billing the goods only as used), and storing surplus stock in warehouses until it can be disposed of. The Packard Motor Car Company, Procter and Gamble, the National Cash Register Company, the International Harvester Company, and at least some dozens of other companies have used plans of this type successfully. The method would not be feasible, of course, with products that are very perishable or subject to sudden changes in style.

Another remedy which has possibilities of extension is the development of "side lines" that can be made during the slack seasons by the same working force as is used in the manufacture of the main product. The Beechnut Packing Company, which formerly packed only bacon, added peanut butter, chewing gum, crackers, and various kinds of canned goods to fit in with the highly seasonal packing of bacon. A concern manufacturing ice cream cones, which are consumed chiefly in summer, is now also making sugar wafers and candy bars, which find their greatest market in winter. The S. L. Allen Company supplements the manufacture of agricultural implements with the production of children's sleds at certain times of the year. The side line must be chosen, of course, with great care, for not only must it be something that the regular working staff can make, but it should also be a product that the regular sales force can sell. Otherwise, the whole purpose of the scheme will be defeated.

Some, though relatively few, concerns have adopted the so-called "flexible working week" for the purpose of reducing seasonal unemployment. The National Suit and Cloak Company, a large mail-order house with branches throughout the country, used to have very great seasonal fluctuations in their New York office. In remedying this situation, they reduced their normal working week to about forty-four hours. On this basis they established a flexible working week, so that in their peak periods they could work up to fifty-one hours and in their valley periods as few as thirty-nine hours; in other words, they distributed their load among their present people, without reduction of wages. The meat-packing house of George A. Hormel and Company adopted, in 1934, the practice of paying its workers in 52 weekly installments, regardless of the number of hours worked in any particular week; the Nunn-Bush Shoe Company also pays wages to its permanent employees in 52 equal installments; and the Procter and Gamble Company guarantees its employees, after two years of service, not less than 48 weeks of work a year.[18] Other firms that use the flexible working week in some form or other are the Delaware and Hudson Railway, Leeds and Northrup of Philadelphia, and the Columbia Conserve Company.

It should be noted that stabilization of employment by methods of this kind appears to be in conflict with the Fair Labor Standards Act of 1938 which requires the payment of "time and a half" for work done in excess of forty hours a week. Employers interested in stabilization are hoping that means may be found to resolve this apparent conflict.

By-products of Stabilization. These few illustrations give some idea of the efforts now being made to lessen the volume of seasonal unemployment. It is fair to say, however, that thus far we have merely scratched the surface of this problem. The vast majority of employers have done little or nothing to stabilize production throughout the year. We may expect, however, to see an extension of the regularization of employment as business men come to realize that steady work for their employees is not only good ethics but good business as well. For the best workers tend to seek out those firms that provide regular employment through the year, and are even willing to accept *hourly* wages lower than the current rates, in

[18] An excellent summary of efforts to stabilize employment is given in "Reducing Fluctuations in Employment," No. 27 of Studies in Personnel Policy, Supplement to *The Conference Board Management Record*, New York, National Industrial Conference Board, November, 1940.

order to enjoy a larger *annual* income. The assurance of steady work is also the proper antidote for "soldiering on the job," which is frequently practiced in order to avoid temporary layoffs.

This does not mean that we shall soon witness the total disappearance of seasonal unemployment. In dealing with commodities that deteriorate in quality when stored, that are affected greatly by frequent changes in style, or are so bulky that storage charges are practically prohibitive, the possibilities of manufacturing for stock are seriously restricted, and in many cases are eliminated altogether. Professor Douglas, who has given much thought to the matter, believes that even if manufacturers and merchants could be persuaded to do their utmost to reduce seasonal fluctuations, it is highly improbable that the total amount of seasonal unemployment could be cut by more than one-third. This would be a great achievement, to be sure, but it would not solve the problem completely, for it would still leave (according to Professor Douglas's calculations) a residue of something like 4 per cent, on the average, of our American workers deprived of income by seasonal fluctuations in business activity.

The Handling of Technological Unemployment. Any attempt that might be made to reduce technological unemployment raises at once the perplexing question of whether we should try to remove the causes of permanent layoffs, for, as we have seen, these causes consist chiefly of improvements in mechanical and managerial technique or of changes in consumers' demand. It would scarcely seem desirable, from the social point of view, to interfere with the "good management which causes technological unemployment." Better methods of production mean a larger social income, and no nation is as yet so surfeited with goods that it can afford to spurn additions to its volume of commodities and services. It would appear unwise, also, to undertake to block permanent changes in demand, for these changes represent shifts in consumers' purchases made in the effort to maximize satisfactions. The decline of horse-drawn vehicles and the rise of the automobile constituted changes in demand which doubtless brought technological unemployment to carriage-builders, but the net gain to society in the way of better transportation facilities is beyond all question.

Technical Advance and the Volume of Employment. It must be remembered, moreover, that technical progress does not necessarily lead to less work for the employees of the industry affected, or for workers in general. The improvements that are introduced may re-

sult in lowered costs and price reductions, bringing the commodity within the purchasing range of a much larger group of buyers and thus increasing greatly the quantity disposed of. This happy sequence of events would be possible, of course, only in the case of goods for which the demand is *elastic*—the total amount expended for the commodity increasing with a reduction in price. The automobile is a commodity of this type, and it is significant that, though tremendous technical advances have been made in the field of automobile manufacture, the normal number of workers in that industry is now greater than ever before. If, because of technical improvements, the price is lowered in the case of a good for which the demand is *inelastic,* less will be spent for that commodity than before, but the unspent remainder will be available for the purchase of other goods. In this event not all of the old employees could expect to retain their jobs; those displaced by the changed conditions of production would have to look for work in other fields of economic activity.

If monopoly control made it possible for the enterpriser to keep up the price of his product even though technical change had brought a great reduction in the costs of production, his larger profits would be spent for either consumers' goods or capital, and would thus tend to "make work" in other industries for his displaced employees. The economists are correct, then, in their contention that the use of labor-saving devices or better methods of management does not *permanently* reduce the total volume of employment in society. But they may, and often do, throw men out of work *temporarily,* and with quite serious effects upon the individuals concerned. If the men laid off are the least desirable of the working staff (as is likely to be the case), if they are over rather than under forty-five years of age, and if (as usually happens) they refuse to believe that there is no chance of getting their old jobs back, the period of readjustment may cover many months.

Planning for Technological Changes. But though there may be ample reason for insisting that industrial progress shall not be impeded, there is little justification for ignoring the plight of the workers whose loss through technological unemployment is coincident with society's gain. Many employers, as well as others, feel that it is the duty of economic society to lend aid to workers who must make occupational changes because their jobs have been wiped out by the adoption of better methods of production. One way to help

is to plan ahead for the introduction of the new arrangement. The major discoveries in industrial technique do not ordinarily come into being overnight, but are developed gradually over a period of months or years. In every business there is a continual loss of employees, resulting from voluntary separations on the part of workers who think they see better opportunities elsewhere. It is often possible to take advantage of this fact, reducing the working force slowly by not hiring new employees to take the places of those who have resigned. By the time the new process goes into operation, the natural flow of labor from the plant has, in part at least, solved the problem of layoffs. Moreover, the new device can often be introduced by degrees, as was shown by Fels and Company in the installation of soap-wrapping machines, each of which did the work of 250 women wrapping by hand. Two machines were needed to handle the firm's output, but the second was not put in until the staff of hand-wrappers had been depleted by death, marriage, and resignation—but not by discharge. It is doubtless true that industry cannot always be so considerate, but business enterprisers should be given to understand that there are certain obligations which they owe to their employees, and that society will not excuse technological unemployment which might have been avoided through the exercise of foresight and advance planning.

Aid in Making Readjustments. It is not too much to demand that business concerns, instead of casually turning workers loose to shift for themselves, shall first make a genuine effort to transfer them to other work in the same plant, and failing in this try to place them with other firms. Surely this much at least is due men and women who have cast their lot with a business establishment and in many instances have given long years of unstinted service to their employers. The problem is too involved, however, to be solved by employers alone. There is need of vocational guidance for the young, so that they may be warned against going into industries that are in process of shrinkage; need of employment exchanges to offer encouragement and advice in the case of those unavoidably laid off; and need of retraining for those unfortunate workers who, because of conditions over which they have no control, find their occupations gone beyond recall. There should be, then, the development *at public expense* of a definite plan for handling the many and difficult problems that the rush of technical progress is forcing upon us.

Public Employment Agencies

Cyclical, seasonal, and technological unemployment could all be lessened somewhat if provisions were made for placing the unemployed workers promptly in whatever jobs happen to be open. Even in periods of the greatest cyclical unemployment, there are some jobs that remain unfilled simply because the right men do not chance to apply for the openings. We have been remiss in not developing in the United States the machinery for putting unemployed workers in contact with unfilled jobs. As a consequence, many workers, who could be placed satisfactorily under a sound system of employment exchanges, now walk the streets looking despairingly for openings which are unattainable only because their existence is unknown to the jobless.

The Inadequacy of Private Employment Agencies. The agencies we now have for placing labor are far from adequate. There are, for example, several thousand private employment bureaus, but many of these are inefficient or dishonestly operated. Some bureaus charge unreasonably high fees, raise their fees in times of greatest scarcity of jobs, split fees with the foremen who hire their applicants, and indulge in other highly objectionable practices. There are properly conducted private agencies, of course; but so flagrant have been the abuses and so inefficient the services rendered that fee-taking private agencies are not allowed to operate in certain countries. Some employers' associations maintain employment offices, but experience proves that they are likely to degenerate into agencies for blacklisting active unionists and thus prove an obstacle to union organization and collective bargaining. Strong trade unions sometimes place their members through employment offices of their own, but this arrangement is of no assistance whatsoever to the non-unionists who constitute the great bulk of American wage earners. Philanthropic institutions, such as the Young Men's and Young Women's Christian Associations, frequently attempt to find jobs for applicants, but their scope of activity is necessarily limited.[19]

A Public Employment Service. Students of the problem of unemployment are in general agreement that if we are to reduce unemployment to a minimum in this country, we must develop a system

[19] The pros and cons of private employment agencies are dealt with in some detail in Paul H. Douglas and Aaron Director, *The Problem of Unemployment*, pp. 266–281.

of public employment exchanges that is large enough to cover the whole industrial United States. "Since the non-public agencies together fall short of meeting the quantitative needs of employment contract-making, since they leave important fields untouched which in the public interests should be provided for, and they are not well adapted to the requirements either of impartiality or of service on a coordinated national scale, we are led to conclude that the development of a national system of public employment bureaus seems to offer the greatest immediate promise of meeting the unified and growing wants of industry and the community." [20]

We Americans are not without experience in the business of finding work for the unemployed, for we established in January, 1918, the United States Employment Service, a public agency under the Department of Labor, which at one time had as many as 850 offices in operation throughout the country. Laboring under great handicaps, and with the opposition of private employment bureaus and the National Association of Manufacturers,[21] the Service placed about two and a half million workers during its period of greatest activity, the year 1919. Later, however, the federal employment offices were taken over by states or municipalities, and the national government's part in the service was confined largely to providing federal aid and exercising general supervision over the several branches of the system. This arrangement was far from satisfactory. In many instances, the offices were poorly located and badly kept. The salary scale was usually inadequate, and the personnel often both incompetent and indifferent. There was little or no coordination and cooperation between the various exchanges, and no uniformity in record-keeping. No serious attempt was made to enlist the support and patronage of business men, who could frequently have rendered invaluable aid in finding work for the unemployed.

The Wagner-Peyser Act. These are some of the defects which, coupled with the abuses practiced by the private agencies, led to the passage of the Wagner-Peyser Act in 1933. This Act attempted to remedy the situation by revamping the United States Employment Service, and having it operate a system of employment offices in cooperation with the states. There are public employment offices

[20] Shelby M. Harrison, *Public Employment Offices*, New York, Russell Sage Foundation, 1924, p. 102.

[21] The private bureaus wished, of course, to eliminate competition, and the National Association of Manufacturers charged the Service with wastefulness, inefficiency, and *bias in favor of union labor.*

in every state, about 1600 in all, which provide free service to workers and employers. In some 3100 other places where there are no offices, representatives of the state employment service come at regular intervals to receive applications for jobs, to put employers in touch with suitable workers for job vacancies, and to render other services. In 1938, 1939, and 1940, this federal-state service registered some 45 million applicants for jobs, and made about eight million placements in private employment and two million in public employment.

Nevertheless, this federal-state system of employment service has not been wholly satisfactory. It would seem better to have a chain of offices operated by the federal government than for the federal government merely to give encouragement and aid to employment offices initiated by the several states. Among other things, there is need for a central clearing house of information, so that openings may not go unfilled when there are workers in other states who are able and willing to take the jobs. A nationally operated system of public employment exchanges appears to be one of the prime essentials to the solution of the problem of unemployment. It should be noted that President Roosevelt by Executive Order, placed the state employment offices under federal control on December 19, 1941. However, on July 26, 1946, President Truman signed a bill which provided for the return of these employment exchanges, as of November 16, 1946, to pre-war status under state control.

Planned Public Works

Another type of public aid that has been widely endorsed is the construction of needed public works in periods of business depression. In the past, we have been inclined to build our post offices and and court houses, dig our sewerage ditches and subways, and construct state and national highways when business in general was booming rather than during hard times. This custom is doubly wasteful. First, since prices are high in periods of prosperity, the cost of public works built in these periods is correspondingly high. In the second place, and of particular importance in connection with unemployment, public construction, if carried on when business in general is depressed, would provide work for many thousands of jobless men. Moreover, the wages paid these men would constitute purchasing power for commodities in the making of which still others would find employment.

Possibilities of Relief Through "Public Works." It is impossible to say just how much relief might be afforded by the planning of public works so as to level off the peaks and fill in the depressions of private business. To begin with, it must be confessed that we know very little about the total volume of public construction work in the United States. The estimates run all the way from one billion to two and one-half billion dollars' worth of building annually. Doubtless some of this work is urgent and must be completed at once, but there is unquestionably a part—and again we do not know how much—that could be delayed for a year or several years without social loss. If, during years of unusual business activity, a half or even a quarter of the work on public construction could be postponed and reserved for years in which employment is below normal, the effect would be most salutary. Not only would poor business be boosted by the adoption of this arrangement, but good business would be kept from running amuck. "In substance this type of control over public expenditures for construction is analogous to the attempts of central banks to control the volume of credit and through that the volume of business activity. Both methods contemplate the avoidance of inflationary practice; and both, in order to be effective, must come to an arbitrary decision regarding the proper rate of expansion of business activity, of industrial output, of bank credit, or of whatever criterion of inflation may be chosen." [22]

Shortcomings of Planned Public Works. Our lack of data and the necessity of exercising arbitrary control are but two of the difficulties encountered in attempting to utilize the construction of public works in the stabilization of employment. Another obstacle to the smooth functioning of the plan is the rather narrow range of jobs available in undertakings of these kinds. Though there may be an abundance of employment for skilled workers in the building trades, and sufficient work to keep thousands of pick-and-shovel men busy, it does not appear just how our displaced salesmen, clerical workers, silk weavers, shoe operatives, and factory employees in general can fit into the scheme. Public works offer little or no direct aid to the women in industry whom unemployment has left without incomes. Public construction, moreover, may be greatly needed in those sections of the country where unemployment is least acute, and may not be called for at all in areas in which the jobless are most nu-

[22] Leo Wolman, *Planning and Control of Public Works*, New York, National Bureau of Economic Research, Inc., 1930, p. 173.

merous. Also, in some cases, much shifting of labor would be entailed, and this is both troublesome and expensive.

Even more serious is the lack of centralization of authority for public building projects, and the consequent inability to control public works through a federal agency. Unemployment of the cyclical type is usually country-wide—sometimes world-wide—and to apply the suggested remedy of planned public works with full success in the United States would require a central agency that not only knows of the contemplated public construction plans of the municipal, county, state, and national governments, but has the authority to modify these plans in the public interest. But the present situation is that the various governmental units control their own expenditures for public works, and ordinarily guard most jealously their rights in this respect. Since probably not more than 10 per cent of the *routine* public construction work in this country is under federal direction, the difficulties of developing a unified system of planned public works are obvious.

The several obstacles that appear to stand in the way of effective planning of public works for the relief of unemployment may eventually be surmounted. They are presented not as proof that a plan of this kind is unworkable, but simply to stress the fact that, despite the glowing optimism of its sponsors, this method of unemployment relief has yet to prove its feasibility.

The Roosevelt administration provided an example of huge expenditure for public works—though, of necessity, hastily planned public works—for the purpose of relieving business depression and promoting recovery. Congress appropriated many billions of dollars for carrying on "relief work," which consisted of federal public works, conservation projects, highway improvement, non-federal public works, low-cost housing, rural resettlement, and light construction, mainly under the direction of the Public Works Administration and the Works Progress Administration (later called the Work Projects Administration). In some instances, the work was of a strictly federal nature, such as the building of new post offices, but in many cases the government made outright grants to localities up to as much as 45 per cent of the cost of labor and materials on approved projects, and lent the balance at 4 per cent interest.

The chief object of these projects was, of course, to get money into circulation as fast as possible, to carry on undertakings which involved the use of labor (so as to reduce the number of the unem-

ployed), and to provide relief in the guise of work rather than as a direct dole. Since this is true, and since the work done was not a part of a carefully planned, long-run program of public works, it is probably true, as critics of the Roosevelt administration have charged, that a large part of the billions of dollars spent on "made work" was spent uneconomically. It is likewise true, as all social workers know, that indirect relief of the kinds noted above is more costly than a direct dole, if considered solely on the basis of dollars and cents expended; but it may well be worth the extra cost to give men jobs that are not very productive of economic goods, if by so doing we can avoid the loss of morale that goes with the long-continued acceptance of charity.

Unfortunately, this recent experience with public works in time of depression tells us little of what might be accomplished by means of a thoroughgoing program of planning of the kind we discussed earlier in the chapter. The passage of the Murray-Patman Employment-Production Act suggests that the need for such a program has at last been recognized; and it is reasonable to suppose that we could, with the aid of the President's Council of Economic Advisers, do a better job of handling public works than we have yet done. Though employment increased in volume during the progress of the programs carried on by the Public Works Administration and Works Progress Administration, it is impossible to say to what extent the decline in unemployment should be credited to these agencies. The fact that they provided direct employment to some millions of workers probably does not tell the whole story of their service in this respect. For the gain in employment in many businesses throughout the country must have been due, in large part, to the purchasing

TABLE 4. EARNINGS OF PERSONS EMPLOYED UNDER FEDERAL WORKS PROGRAMS, 1933–1940, INCLUSIVE [a]

1933	$ 521,239,000
1934	1,094,895,000
1935	923,021,000
1936	2,551,683,000
1937	2,003,985,000
1938	2,488,369,000
1939	2,405,148,000
1940	2,074,088,000
Total	$14,062,428,000

[a] Source: *Social Security Bulletin*, February, 1940, and January, 1941.

power placed in the hands of these publicly employed workers. The direct aid to workers, in the form of wages paid to persons employed under the federal work programs during years of severe unemployment, is indicated in Table 4. It will be noted that these earnings were approximately 2½ billion dollars in each of three years, and *averaged* more than 1¾ billions annually over the eight-year period from 1933 to 1940, inclusive.

Unemployment Insurance

But it is not enough to attempt to stabilize business, to provide for public employment exchanges in order to make the most of whatever work is available, and to try to increase the amount of employment when it is most needed by encouraging public construction in periods of business depression. Despite our best efforts along these lines, it is probable that we shall have an unemployment problem on our hands for many years to come. This means that if we are to prevent distress and suffering in times of unemployment, we must undertake to provide the jobless with incomes large enough to enable them to buy a sufficient amount of food, clothing, and shelter.

Personal Provision and Private Charity. Heretofore we have gone on the comfortable assumption that the American workingman, if he was industrious and thrifty, could so arrange his finances as to make the fat years take care of the lean. But each recurrent business depression, with its appeals for help for workers and their families, demonstrates the falsity of this assumption. Ordinarily we place the blame for lack of savings on the workers. "When the laborers' pockets are full, they forget that there is such a thing as empty pockets," is a common lament of the well-to-do. The fact is, however, that the vast majority of our workers have never experienced the luxury of a financial surplus. Two studies of the National Industrial Conference Board[23] (a business men's research organization) present some illuminating data on this point. The first shows that the average weekly wage in manufacturing industries in 1927—when, it might be assumed, workers would be saving against possible unemployment in the future, such as that of the post-1929 depression—was $27.44, or $1426.88 for a full year of fifty-two weeks. The second of these studies estimates the average minimum cost of living in twelve

[23] *Wages in the United States, 1914 to 1927* (1928), and *The Cost of Living in Twelve Industrial Cities* (1928), National Industrial Conference Board, New York.

industrial cities at $1556.[24] For 1937, the Conference Board estimated the average full-time wages at $1407.64 (average weekly wage, $27.07), and the cost of living at $1450. There is no need to point out the difficulty of providing for cyclical unemployment out of wages that, even in good times, are too small to buy a sufficient quantity of economic goods. Since these are *average* wages, there are some workers, of course, whose wages are more than adequate to take care of their *minimum* needs, but there are likewise some whose earnings in most prosperous times are too small to provide them and their families with a "health and decency" standard of living. It is true, of course, that wages are now higher than in 1927 or 1937, but so also are prices. The sad fact is that millions of American families are unable to save from their current income anything like enough to tide them over periods of unemployment.

When those who are always impoverished fall upon the specially hard times of unemployment, we have expected charitable organizations to look after them; and when, as in the great depression of 1929, the resources of organized charity prove wholly inadequate, we have appealed to the public to contribute to relief funds. There are at least three serious objections to this method of procedure. First, the voluntary contributions are not always forthcoming, as is shown by the failure to raise a $5,000,000 relief fund in Philadelphia to meet the urgent needs of 1930–31. Second, this plan does not conform to the generally accepted theory that in meeting public obligations the burden should be distributed on the basis of ability to pay. When giving is "voluntary," some who could give millions give thousands or hundreds instead, and employed workers whose families need their entire earnings are virtually forced to give a day's pay a month, or some other amount set by an employer who wants his firm to show up well in the published list of contributions.

Finally, there is no disguising the fact that assistance coming from donations of this kind is charity, and no one who is able and willing to work should be humiliated by being asked to accept charity. Rather, he should receive whatever he gets as a *right,* and not as a gratuity. Perhaps the world does not owe anyone a living, but it may well be argued that it owes every man a *chance to earn a living.*

[24] It is probable that these figures present a more favorable picture than the actual conditions warrant. Professor Douglas estimated the average wage for 1926 at $1376; and Professor W. I. King, for 1927, at $1205. Moreover, most social workers consider it impossible to maintain the hypothetical family of four in comfort for less than $2000 a year, with prices at the 1926 level.

Surely an industrial society which is so organized that men are denied the privilege of working can properly be charged with the responsibility of maintaining those from whom the means of livelihood are thus withheld. This point was emphasized by President Roosevelt in a speech made on the third anniversary of the passage of the Social Security Act of 1935, in which he said: "The millions of today want, and have a right to, . . . the assurance that with health and the willingness to work they will find a place for themselves in the social and economic system of the time." [25]

When emergencies arise calling for the expenditure of large sums of money, this money, though perhaps borrowed immediately, should come ultimately from revenue derived from taxation. This is the one sure way of obtaining whatever funds are required, and the most likely way to spread the burden so that it will cause a minimum of sacrifice. In the case of unemployment funds, they should be paid to the jobless as a frank acknowledgment of society's failure to measure up to its obligation to provide work for those who want it. And society can scarcely be said to be discharging this obligation with undue liberality when it gives (as, according to Professor Paul Douglas, it gave during the post-1929 depression) its involuntarily unemployed an average of $20 per month per family.

The Principle of Unemployment Insurance. But a better plan for enabling the unemployed to survive hard times has been in use in Europe for a long time, and in the United States for something more than a decade. We refer to unemployment insurance, which aims to apply to the problem of unemployment the well-known principle of risk-spreading. Unemployment, like fire and death, is the portion of some, but not all, in a given period, but no one can predict with certainty just which members of the group will be afflicted. It is possible, however, to insure against the economic dangers of an evil such as unemployment, through the regular collection of small premiums for all who *might* suffer temporary or permanent layoff and consequent loss of income, and the payment of benefits to those to whom unemployment actually comes. The benefits that can be paid depend, of course, upon the size of the premiums, but care is always taken to see that these benefits are not so large as to make unemployment attractive to workers.

In unemployment insurance, there is always the possibility that the funds provided by collecting premiums may prove inadequate

[25] *The New York Times,* August 16, 1938.

for the payment of promised benefits if the period of unemployment is unexpectedly extended and severe. This, indeed, was the experience of the British, who found it necessary, upon the exhaustion of their unemployment "reserves" during the long siege of unemployment that followed the close of World War I, to pay relief benefits provided through receipts from taxation.

Unemployment Compensation Under the Social Security Act of 1935. The passage of the Social Security Act in August, 1935, marked the first attempt of the people of the United States to provide unemployment compensation on a nation-wide basis. Wisconsin and one or two other states had already adopted insurance of this kind, but the movement had been held back by the fear that in passing laws that made unemployment insurance compulsory a state would place its industries at a disadvantage in competition with industries in states which had no such laws.

The unemployment section of the Social Security Act solved this particular problem by imposing a federal tax of 1 per cent for 1936, 2 per cent for 1937, and 3 per cent per annum thereafter, on payrolls in general throughout the United States. The federal government itself does not provide unemployment insurance, but it encourages the states to so do, by allowing employers to credit as an offset against their federal tax any amounts which they contribute under an approved state unemployment fund, except that the total credit may not exceed nine-tenths of the federal tax for any given year. This one-tenth of the tax, which must be paid to the federal government in any case, is used to assist the states in the administration of their unemployment plans.

Since the employers in every state must pay a 3 per cent payroll tax, either to the federal government or to the state and federal governments combined; since the federal government has removed the fear of putting the employers of one state at a disadvantage with those of another, by making the tax nation-wide; since it offers the states financial assistance in paying the costs of administering their insurance plans; and since none of the money will be spent within a state unless a local unemployment insurance plan is adopted, it is evident that a state has much to gain, and little if anything to lose, by giving its people the protection of unemployment insurance. The result, as has been charged by opponents of the plan, is a system of unemployment compensation which is virtually forced upon the states by the federal government.

Among the specific standards to which every state insurance plan must conform are the following: The benefits that go to the unemployed must be paid through "public employment offices in the state or such other agencies as the Social Security Board may approve"; all monies received by the states in their unemployment funds must be paid over at once to the Secretary of the Treasury, to be placed in the Unemployment Trust Fund, and all money withdrawn by the states from the Fund must be used solely for paying unemployment benefits; benefits must be paid to those who would otherwise be eligible if these unemployed workers refuse to accept new jobs (1) because "the position offered is vacant due directly to a strike, lockout, or other labor dispute," (2) because "the wages, hours, or other conditions of the work offered are substantially less favorable to the individual than those prevailing for similar work in the locality," or (3) because acceptance of the job involves signing a "yellow-dog" contract; and, finally, the states must reserve the right to alter the plans at will.

Unemployment Compensation in Operation. By July, 1937, unemployment plans had been adopted by all of the forty-eight states, the District of Columbia, Alaska, and Hawaii. By July, 1938, twenty-eight states were already paying unemployment benefits, and by July, 1939, the unemployment compensation laws of all the states had been in force at least two years, so that all states had by that date attained full benefit-paying status.

The total annual amounts that were disbursed in the form of unemployment benefits from 1938 to 1945, inclusive, are given in Table 5. The total benefits for the eight years amounted to slightly more

TABLE 5. ANNUAL PAYMENTS MADE UNDER FEDERAL-STATE UNEMPLOYMENT COMPENSATION PROGRAM, 1938–45 [a]

Year	*Total Payments*
1938	$ 393,786,000
1939	429,298,000
1940	518,700,000
1941	344,321,000
1942	344,084,000
1943	79,643,000
1944	62,385,000
1945	341,681,000
Total	$2,513,898,000

[a] Source: *Social Security Bulletin,* January, 1946

than two and a half billion dollars, with an annual average of $314,-237,000. About thirty-six million persons have established "wage credits" under the provisions of the Social Security Act, and are thus made eligible to draw benefit payments in time of unemployment. The average weekly benefit paid for full unemployment was $13.84 in 1943, and $15.87 in the second quarter of 1944. About 530,000 unemployed workers collected unemployment benefits sometime during 1944.

Shortcomings of the Plan. In several respects, this federal-state provision for unemployment insurance falls short of meeting the needs of the country for protection against involuntary idleness. First of all, the Social Security Act fails to cover those workers who are employed in establishments not having a labor force of at least eight workers for at least twenty days a year (each day being in a different calendar week), and workers who are employed by relatives. It excludes, also, all agricultural workers, domestic servants in private homes, officers and crews engaged in shipping in United States waters, public employees, and employees of non-profit-making organizations. Because of these exclusions, it is probable that not more than two-thirds of our "gainful workers" enjoy unemployment benefits under the Act. On this point, President Roosevelt said, in 1938: "To be truly national, a social security program must include all those who need its protection. Today many of our citizens are still excluded from old-age insurance and unemployment compensation, because of the nature of their employment. This must be set aright; and it will be." [26]

Another weakness of the plan is its lack of uniformity as between the states. To the lawmakers of the individual states is left the vital matter of the degree of security the workers are to enjoy. The result is federal-state unemployment insurance of many varieties. The *maximum* pre-war weekly benefit payment was $15 in forty states (or jurisdictions), $16 in five, and $18 in six; the *minimum* weekly payment (when specified) ran from $1.50 in North Carolina to $10 in California. But the weekly benefits actually paid in 1940 for total unemployment ranged from $4.68 in North Carolina to $14.14 in California, with an average of $10.57 for the country as a whole. The average *annual* benefits paid in 1940 were $100.15 per worker for the country, with a low of $42.60 in South Carolina and a high of $174.12 in California. Workers must usually be out of work for

[26] *The New York Times*, August 16, 1938.

two to three weeks before benefit payments begin, and in most states the maximum number of weekly payments a worker can receive in a year is sixteen, though in five states it is twenty-six. The maximum benefits were raised in some states during World War II, and now go as high as $22 a week.

It is reasonable to suppose that if industries can build up surpluses from profits for the payment of dividends in lean years, as they now do, they can likewise afford to contribute, and should be compelled to contribute, to unemployment insurance funds from which benefits can be paid in periods of enforced idleness.[27] The compulsory feature of the Social Security Act is important, for American experience has shown that employers are slow to adopt social insurance of any kind, unless required to do so. In only five states are the workers required to contribute to the unemployment funds, so that the burden at present falls almost wholly upon the employers. But it seems desirable that the federal government also should contribute to the unemployment reserve funds, not only to make possible the payment of larger benefits, but also to emphasize its responsibility in failing to remedy cyclical fluctuations (which, as we have seen, are not directly chargeable to individual concerns) and to justify the control of these reserve funds by the government. Unemployment is not only a local but a national problem as well; and we feel strongly that unemployment insurance, like public employment exchanges, should be administered on a country-wide basis by a federal agency.

The Railroad Unemployment Insurance Act of 1938. Three years after passing the Social Security Act, Congress produced a new unemployment compensation plan which applies to workers on railroads engaged in interstate transportation. This plan, as provided for in the amended Railroad Unemployment Insurance Act, places a uniform 3 per cent payroll tax on employers, and grants benefit payments which are weighted in favor of workers in the low-wage groups. There are seven classes of benefits, ranging from $1.75 to $4 a day for time lost through unemployment, with a maximum benefit of $17.50 to $40 for any fourteen-day period. The maximum annual benefit for an individual worker is $175 to $400, depending upon his classification. The million or more railroad em-

[27] Dividends and interest paid in the United States were $428,500,000 greater in 1930 than in 1929, while wage payments fell off $9,600,000,000, according to estimates of the Standard Statistics Company.

ployees who come under this plan are, of course, no longer covered by the provisions of the Social Security Act.

This program of strictly federal unemployment insurance has several points of superiority over the federal-state plan which we have had since 1935. It is uniform throughout the country, so that the workers who are covered receive benefits which are not dependent upon the liberality of state legislators. It pays benefits that are substantially larger than those paid under the provisions of the Social Security Act. It favors the lower-paid workers, upon whom unemployment usually falls most heavily. It is far simpler to administer than the Act of 1935, since it avoids the many complications which are inherent in a federal-state system.

Need for a National Unemployment Program. The Railroad Unemployment Insurance Act seems to point the way for definite improvements in our broader system of unemployment compensation. For the sake of efficient and economical operation, our present hybrid scheme should be replaced by *national* unemployment insurance. In the interests of adequate compensation, without which an insurance plan is mere pretense, we should increase the benefit payments until they at least equal those now prescribed for the railroad workers. And in the name of common justice, we must expand the program to admit the large groups of workers who are now without protection against the hardships of involuntary idleness. The Social Security Board has urged that the coverage of the federal-state unemployment plan be extended to those who are not now included, that the maximum benefits for full-time unemployment be made not less than $25 a week, and that payments be payable for a total of at least twenty-six weeks in a year.[28] Under the provisions of the Servicemen's Readjustment Act of 1944, commonly known as the "G.I. Bill of Rights," unemployment benefits of $20 a week, for a maximum of fifty-two weeks, were granted to veterans of World War II who had had at least three months of service, but this is a temporary expedient designed to aid the returned soldier while he is making adjustments to a peacetime economy.

Conclusion. In dealing with the problem of unemployment, we have often been able to give only a page or two to the description of phases of the subject about which whole volumes have been written. Our treatment represents, therefore, only the barest outline of the problem and the plans proposed for its solution. The seriousness

[28] *9th Annual Report, 1944, of the Social Security Board,* pp. 8, 9.

of the unemployment problem is undeniable. So far as remedies are concerned, there is little that can be said with assurance. The truth of the matter is that we are just beginning to give this problem the attention that it deserves. What does seem reasonably clear is that in relatively few cases are the workers themselves responsible for unemployment or for the lack of savings to tide them over the period of enforced idleness. The responsibility lies, rather, with individual employers and especially with the industrial system as a whole. Consequently, it is the duty of business men and of the state to see to it that the volume of unemployment is cut down materially, and that whatever part remains shall not be allowed to bear too heavily upon those affected. It is believed that earnest attempts to stabilize business, to control the construction of public works, to improve our facilities for the retraining of workers, to provide jobs through public employment exchanges, and to develop a sound system of unemployment insurance, can do much to solve this most serious of the several problems of economic insecurity.

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1. "One of the distinctive features of modern economic life is the separation of the worker from ownership of the tools with which he performs his daily tasks." What has this fact to do with the problem of unemployment?
2. "The loss of a job may spell tragedy." Why? Describe the sort of tragic consequences that result from the inability to get steady work.
3. Distinguish carefully between the several types of unemployment.
4. Summarize the unemployment situation in the United States in the post-1929 depression.
5. In what years in the twentieth century has cyclical unemployment been especially severe?
6. Name several industries in which production is highly seasonal, and explain why it need be seasonal in these particular industries.
7. Professor Slichter speaks of technological unemployment as consisting of *permanent layoffs*. Describe the most important causes of such layoffs.
8. Stuart Chase has written an article about a gigantic new machine which turns out 10,000 automobile frames a day. "When those frames were made by the old 'hand' process," he says, "it took 2000 men to produce 10,000 frames a day. The machine has eliminated 90 per cent of the sometime operating force."
   a. What type of unemployment has been caused by the use of the machine?
   b. Is it probable that the displaced workers will be permanently unemployed?

9. Are *permanent layoffs* and *permanent unemployment* synonymous? Explain.
10. Explain Mr. Lewisohn's statement that "employment may be due to bad management which creates seasonal unemployment or good management which causes technological unemployment."
11. If this statement is correct, should we not welcome rather than decry technological unemployment?
12. Discuss the special difficulties that confront the worker who is made idle by technological unemployment.
13. What is the goal of the Murray-Patman Act, and what is the nature of the procedure through which it is hoped to reach that goal?
14. In what ways are private employment agencies inferior to a nationwide system of public employment exchanges?
15. What was the purpose of the Wagner-Peyser Act? To what extent has it been achieved?
16. Discuss the public works programs of the federal government in the post-1929 depression.
17. What are the advantages of relief through public works as compared with a direct dole? The disadvantages?
18. Describe briefly the unemployment insurance provisions of the Social Security Act of 1935.
19. Discuss our experience with federal-state unemployment insurance from 1935 to 1945.
20. State the defects of this program of unemployment insurance.
21. What can be said for and against a system of unemployment insurance, financed wholly by the employers and the state, with benefits paid as a *right* of the unemployed and not as *charity*?
22. In what respects is the unemployment insurance plan for railroad workers superior to the federal-state plan set up under the Social Security Act?

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6. Economic Insecurity: Accidents, Sickness, Old Age

We continue in this chapter our examination of the problem of economic insecurity, of which unemployment is a major item. In dealing with unemployment we considered men and women who are both able and willing to work, if only they are given the opportunity; but in the case of accidents, sickness, and old age, we direct our attention to those who either are physically incapacitated or have reached an age at which industry has no further use for them. The economic consequences are here much the same as the consequences of unemployment. Without jobs, whatever may be the cause, these "dislocated soldiers of industry" are likewise without incomes, and lacking incomes they are faced with the problem of needing economic goods but having no purchasing power. The problem here, therefore, as in all instances of economic insecurity, arises from the fact that human wants continue as long as life itself, regardless of whether or not the means of satisfying these wants are available.

Industrial Accidents

The Terms "Accident" and "Injury." In discussing the subject of industrial accidents, it is rather common practice to use the words "accident" and "injury" as though they were synonymous. Mr. H. W. Heinrich, a leading authority on accident prevention, points out that this is by no means true, and that much confusion may be avoided by a correct use of the terms.[1] An accident, says the lexicographer, is "an event that occurs without one's foresight," whereas an injury is "any wrong, damage, or mischief done or suffered." Happily, not

[1] H. W. Heinrich, *Industrial Accident Prevention*, New York, McGraw-Hill Book Company, Inc., 2nd ed., 1941, pp. 30–35. (We shall cite also, in several instances, the first edition of this work.)

all accidents result in injuries. And yet, such data as we have relate almost exclusively to industrial *injuries* which are almost invariably referred to as industrial *accidents*. The significance of the distinction will appear in our treatment of the costs and prevention of accidents.

The Number of Industrial Injuries. Our records of industrial accidents are far from satisfactory. In four states (Arkansas, Florida, Mississippi, and South Carolina) no records are kept of industrial accidents or injuries, and in the other forty-four states the figures relate chiefly to injuries for which benefits have been paid under the workmen's compensation acts. But a careful study of such information as we have leads to the estimate that there are some 17,000 fatal industrial accidents in the United States annually, 1,400,000 industrial accidents causing injuries that result in some loss of time, and more than 40,000,000 minor industrial accidents resulting in injuries that require but little attention. Since "for each accident producing a personal injury of any kind (regardless of severity) there are at least ten other accidents,"[2] we arrive at the conclusion that some 400,000,000 *accidents* occur in American industry every year.

Direct and Indirect Costs of Injuries. If we try to express these industrial injuries in terms of monetary cost, the figures arrived at are appalling. Under compulsory state legislation, more than $240,-000,000 in benefits is paid out annually to those who have suffered industrial injury, or to their dependents, and more than $70,000,000 additional for medical services. But compensation payments represent only a fraction of the total costs. Professor Edison L. Bowers has estimated that all types of industrial injuries taken together cause an annual loss of more than 280,000,000 working days, and a wage loss of over a billion dollars. When compensation payments. wage losses, the costs of medical attention, and indirect losses in production are brought together, the total annual loss, Professor Bowers feels, can scarcely be less than four billion dollars.

The importance of *indirect* as compared with *direct* costs of industrial injuries is frequently overlooked. It is easy to see that payments for workmen's compensation and medical care for the injured are costs that are entailed by the failure to prevent accidents. But it has been found, by analysis, that these direct costs are not more than one-fourth as great as the indirect or "hidden" costs that

[2] For the calculations by which these estimates are reached, see *ibid.*, pp. 26, 27, 50.

must be met by the employer, but often are not charged against industrial accidents. The items of indirect costs—that is, those costs over and above payments for compensation and medical aid—are time lost by injured employees but paid for directly by the employer, time lost by other employees (out of curiosity, sympathy, or desire to assist), time lost by foremen and superintendents, spoilage of material, breakage of tools, and so on. Table 6, which is made up from nine cases taken from actual experience, shows the monetary significance of the indirect costs of industrial injuries. With cases such as these before us, it is not hard to believe that the "by-products" of industrial accidents are four times as costly as the compensation and medical payments.

TABLE 6. DIRECT AND INDIRECT COSTS OF INDUSTRIAL INJURIES [a]

Accident No.	Type of Industry	Direct Costs	Indirect Costs
1	Building construction	$209.00	$ 937.00
2	Hardware manufacture	66.00	275.00
3	Not specified	0.00	154.00
4	Woodworking plant	59.00	262.00
5	Machine shop	11.00	49.00
6	Trucking	25.00	140.00
7	Woodworking plant	86.50	379.50
8	Clothing manufacture	50.00	230.00
9	Drop-forge plant	22.00	107.00
	Total	$528.50	$2533.50

[a] Source: H. W. Heinrich, *Industrial Accident Prevention*, 2nd ed., pp. 52–61

We must not quit the subject of costs without reference to the *human* costs involved in industrial injuries. Costs of this kind are, of course, quite incalculable. It is true that state compensation laws undertake to evaluate arms, legs, eyes, and other scraps of human anatomy in terms of dollars and cents; but who would feel fully recompensed if he received in exchange for an arm, as he would in Ohio, a maximum of $18.75 a week for two hundred weeks? To the personal costs of suffering and lifelong physical impairment must often be added a serious loss in earning capacity, and consequently a lowered standard of living. Here are human costs that not only affect the injured man, but bear heavily upon his wife and children as well, as in the case of unemployment.

The Causes of Industrial Accidents. Industrial injuries result from industrial accidents, but what are the causes of the accidents

themselves? Until we have found the answer to this question we lack the knowledge essential to the prevention of industrial casualties of this sort. Nor is it enough to know that the injury was brought about by a fall, a blow, or an explosion. We must know what caused the fall, or blow, or explosion, before we can hope to prevent such accidents in the future. The best practice, therefore, in analyzing the conditions that lead to human injuries is to work back from the *injury* ("the wrong, damage, or mischief done or suffered") to the *accident* (the "event that occurs without one's foresight") and thence to the *cause* of the accident, so that the cause may be removed and a repetition of the accident prevented.

Contrary to popular notion, industrial accidents are not very largely the result of unguarded machinery, open elevator shafts, defective ladders, and other unsafe working conditions that might easily be remedied. It is doubtless true that such causes were once responsible for many and serious injuries, but progress in managerial methods and state legislation have wrought remarkable changes in the physical equipment with which men now work.[3] In seeking the causes of industrial accidents, we cannot do better than examine a study of 75,000 cases analyzed by the Travelers Insurance Company. This investigation disclosed the fact that, according to the customary but improper method of analysis, 25 per cent of these accidents would have been charged to physical or mechanical causes in the plant, but that in reality many accidents falling within this 25 per cent were attributable, wholly or in part, to faulty supervision. The conclusion finally reached was that 10 per cent of the 75,000 accidents were properly chargeable to physical causes, and 88 per cent to supervisory causes, while 2 per cent only were classed as unpreventable.

Since the number of cases entering into this study was sufficiently large to constitute a fair sample of industrial accidents in general, we shall note very briefly the physical and supervisory shortcomings that accounted for these 75,000 accidents. The physical causes listed were unguarded or ineffectively guarded mechanical, electrical, steam, and chemical conditions; congestion and faulty storage of materials; defective machines, tools, and materials; inadequate fire protection and exits, and unsafe floors and openings; improper ventilation, sanitation, and light; faulty layout of operations and ma-

[3] As witness the elaborate and ingenious safety devices described by picture and print in H. W. Heinrich, *Industrial Accident Prevention,* 2nd ed., pp. 168–259.

chinery, and unsafe processes; and unsuitable dress (such as long sleeves and high heels) and the absence of goggles, gloves, and masks. The defects on the side of supervision were faulty instruction; inexperience, lack of skill, ignorance, and poor judgment of employees; poor discipline, including disobedience and "fooling"; inattention and the distraction of attention; such unsafe practices as "chance-taking," haste, and "short cuts"; mental unfitness, including fatigue, violent temper and excitability; and physical unfitness, such as bodily defects, weakness, and fatigue.[4]

Industrial Accident Prevention. Even though we assume that the cases investigated by the Travelers Insurance Company are strictly representative, and that as a consequence 98 per cent of *all* industrial accidents are preventable, it is too much to expect that so high a percentage will actually be prevented. "Some persons, and among them not a few safety engineers and government officials, feel that the limit has been reached in accident elimination; that information about injuries, both fatal and non-fatal, from now on must be received as a matter of course. . . . But such an assumption seems to be unwarranted," says Professor Bowers. Mr. Heinrich believes that "it is entirely possible and practicable to achieve *at least a 50-per-cent reduction in present accident frequency and accident cost* and that this may be accomplished speedily with very little expenditure of money and by the use of executive machinery which is already established."[5] Even more optimistic was the Committee on Elimination of Waste in Industry of the Federated American Engineering Societies. The estimate of this Committee was that 75 per cent of all loss from industrial accidents could be eliminated if proper attention were given to accident prevention.

Certainly the records of some of the achievements in accident prevention are most encouraging. The United States Steel Corporation eliminated 64 per cent of its serious accidents in the period from 1906 to 1929, and 88 per cent of loss-of-time injuries, thus saving 58,533 men from serious injury and 433,205 from injuries that would have caused them to lose some time. By means of accident prevention work, the Fisk Rubber Company saved 10,120 men from injury from 1918 to 1929, preventing loss of wages to the amount of $700,000 and saving $300,000 in compensation insurance premiums. The Boston Elevated Railway succeeded in reducing the *number* of ac-

[4] For the details of this important study, see *ibid.*, pp. 102–111.

[5] *Ibid.*, 1st ed., p. 64.

cidents, from 1927 to 1928, by 20 per cent, and in cutting the *cost* of accidents by 33 per cent.[6] The effectiveness of accident prevention work is often reflected in the rates charged for workmen's compensation insurance. For example, the quarry insurance rate in Pennsylvania is \$3.60 per \$100.00 of payroll; in Alabama, \$4.77; Indiana, \$5.32; Illinois, \$6.57; Kansas, \$7.44; Georgia, \$7.76; Maryland, \$7.99; and New York, \$9.87. It can scarcely be doubted that the low rate in Pennsylvania, which is the lowest in the United States, is related to the admirable safety work conducted in quarrying in that state, and which in one two-year period brought a decrease of 22 per cent in fatal accidents and 14.5 per cent in non-fatal injuries.

We cannot undertake to discuss the details of accident prevention, but must be content to indicate the general principles which have been applied successfully in bringing about reductions in accidents and injuries. Mr. Heinrich lists four such principles: (1) the development of executive interest and participation; (2) accurate analysis of causes; (3) selection and application of remedies; and (4) the enforcement of corrective practices. The point of attack should be the accidents that occur, and not merely the injuries suffered. Not only lost-time accidents, but *all* accidents, whether or not they result in injuries, are worthy of investigation. If a workman falls but is not hurt, good practice demands that the cause of his fall be studied, since the fall constitutes an *accident* which, if repeated, might easily result in *injury*. "In prevention work, the importance of any individual accident lies in its *potentiality* of creating injury and not in the fact that it actually does, or does not, so result."[7] Every accident, then, must be investigated and its cause determined, measures to prevent its recurrence must be devised and adopted, and the executives must see to it that the precautions prescribed are rigidly adhered to. It is only by strict adherence to a definite program that business concerns achieve great reductions in accidents and injuries such as have been cited.

Workmen's Compensation. But the best that can be done in the way of preventing accidents will leave the problem only partly solved. For the total elimination of occupational injuries seems to be unattainable, and so long as any industrial casualties of this kind occur there will be doctor's bills to pay and families to provide for in the event of death or during the period of recovery. All the states

[6] *Ibid.*, pp. 8, 9.
[7] *Ibid.*, p. 88.

but Mississippi have decided that the employers of the injured workers shall help to meet these expenses. In these forty-seven states (and also in the District of Columbia, Alaska, Hawaii, Puerto Rico, and the Philippine Islands), workmen's compensation laws have been enacted, requiring the employers to provide in advance for the payment of a proportion of wages to their employees when the latter are unable to work because they have suffered industrial injury. In addition to these laws, there are two federal compensation acts—the Civil Employees Compensation Act, providing for payments by the government to any of its employees who may be injured, and the United States Longshoremen's Act, specifying the compensation to be paid by employers to longshoremen and harbor workers in case of industrial accidents resulting in injury.

There are many workers in the United States, however, who are not covered by workmen's compensation laws. Most of the state laws make no provision for farm labor, domestic help, and itinerant or casual workers. Workers in industries of special importance in particular states are in some instances deprived of this protection. Those employed in logging in Maine, cotton-ginning in Texas, and distilling in Kentucky are specifically excluded from the benefits of compensation laws; and some 1,500,000 transportation workers, because they are in *interstate* and not *intrastate* commerce, are not covered by compensation legislation. Concerns employing not more than three workers in Ohio, four in New York, and sixteen in Alabama, are not required by their respective states to pay compensation to injured employees, unless the employees are able to get awards through civil suits. Taking the country as a whole, it seems probable that about 80 per cent of all the workers are given protection under the several compensation laws.

The amount of protection enjoyed varies considerably from state to state. Disability benefits usually take the form of weekly payments, beginning after a waiting period of about seven days and extending over a specified length of time. The laws specify that the payments shall consist of a certain percentage of the worker's regular weekly wage. In this matter there is no uniformity between states, the percentage depending upon the liberality of the law, the type of injury sustained, and the number of persons being supported by the injured worker. In most states there is a maximum limit to the amount of the weekly payment that an employee may receive as compensation, with the result that the actual payment is often

considerably less than the percentage provision of the law. The *percentage*, for example, may be 66⅔, and the *maximum limit* $20.00 a week, in which event a worker whose regular wage is $45.00 would draw not 66⅔ per cent of that amount, or $30.00 a week, in compensation, but only $20.00 (the maximum prescribed by law), or 44⁴⁄₉ per cent of his usual income. In a few states the maximum weekly payment is as high as $25.

The number of payments that can be collected depends, again, upon the nature of the injury. In Ohio, the loss of an arm means 200 weeks of compensation; the loss of a leg, 175 weeks; of a hand, 150 weeks; a foot, 125 weeks; an eye, 100 weeks; and a thumb, 60 weeks. In most states there is a maximum period for the payment of benefits, regardless of the seriousness of the injury. The highest maximum that has been set is 520 weeks in Connecticut, and probably the lowest is the 150 weeks in Idaho. Moreover, it is customary to set a maximum monetary award for total or partial disability. This award is occasionally as high as $8000, but is usually considerably less. Maximum death benefits, under workmen's compensation acts, range from $3000 to $15,000, and here again there is no uniformity as between states. The payments made to the United States government employees are somewhat more liberal than the compensation provided for by state laws. An injured government worker receives two-thirds of his regular wages (with a monthly maximum of $116.66) during the period of total disability, and after his return to work a payment amounting to two-thirds of the difference between his earnings before and after the injury. In many instances, of course, he is able to return to his former job or take a position equally well paid, in which case compensation stops immediately. It should be added that in thirty states the workmen's compensations also cover all or certain specified occupational diseases.

Proposed Changes in Compensation Procedure. No one who knows the facts can fail to see that the present situation is socially a vast improvement over the chaotic state of affairs that existed before the passage of workmen's compensation laws. In those dark ages the payment of benefits was either voluntary on the part of the employer or contingent upon the injured worker proving in court that the employer was legally responsible for the accident and liable for damages. The uncertainties and costliness of litigation led to the frequent settlement of claims, out of court, for pitifully small sums. A major injury, such as the loss of an arm or leg, might result

in the payment of a few dollars or hundreds of dollars, or at times in no payment at all; and there are many instances of death claims being settled for as little as $100, or even less. The elimination of the need to prove the employer's responsibility, and the much larger awards that are now made, constitute real progress in the handling of this particular problem of economic insecurity. The fact that workmen's compensation is now taken as a matter of course and is generally regarded as an essential feature of our industrial system is a striking illustration that sweeping changes in labor legislation may, when they are being made, give rise to loud and bitter protests, and yet in comparatively few years be accepted as wholly beneficial to all concerned, for compulsory workmen's compensation had its beginning in the United States only in 1910.

But though the situation is greatly improved, our method of dealing with industrial injuries today is still far from perfect. For a system to be entirely satisfactory it must, first of all, provide abundantly for the economic needs of the injured worker and his dependents, and, in the second place, supply an incentive sufficiently strong to effect a steady reduction in the number and severity of injuries. In view of the amount of compensation provided by the average state law, we can scarcely claim that we "provide abundantly" for those injured by industrial accidents. Since the maximum weekly benefits range from $12 to $25, or $624 to $1300 per year, while the amount necessary for the maintenance of a minimum standard of living is set by experts at $1500 to $2000 a year, the inadequacy of the payments is obvious. Moreover, the maximum number of weekly payments and the maximum monetary award specified by law do not guarantee, by any means, that even the payments of $12 to $25 a week will extend over the whole period of disability. In twenty states only does compensation continue for life in the event of total disability. Medical service, which is provided for in the workmen's compensation laws of all states, is often quite inadequate, being limited in some instances to a few weeks or months, and, again, by a maximum expenditure of a very moderate amount, say $150 or $200. Death benefits are definitely limited in all but seven states, amounting usually to about three times the annual earnings of the deceased.

When workmen's compensation first gained prominence in this country, it was hoped and confidently expected that the desire to keep insurance rates down to a minimum would lead employers to

guard the safety of their workers so diligently that the number of industrial fatalities and injuries would be materially reduced. It is impossible to say definitely to what extent the introduction of workmen's compensation has furthered the good work of accident prevention. Certainly the predictions made by the early champions of compulsory compensation have not been fully realized. Some excellent prevention work has been done, as we have seen. But in many plants production seems to be conducted in much the same manner as before, with little attention given to safety work, and insurance premiums charged against costs of production as a necessary and unavoidable expense. It would appear, then, that employers in general are not yet convinced that it is cheaper to prevent accidents than to pay compensation. We have failed, therefore, to meet the second requirement of a sound system of accident compensation, which, as we have already noted, is to provide an inducement that will lead employers to give proper attention to the prevention of industrial accidents.

It seems probable that the goals of *adequate compensation* and *accident prevention* can best be reached through the agency of a substantial increase in compensation benefits of all kinds. This increase not only would add to the comfort of the injured workers and their families, but, unless it was accompanied by a sharp decline in the number and seriousness of injuries, would inevitably be paralleled by a material increase in insurance rates. By making accidents very expensive to employers, it should be possible to arouse wider interest in thoroughgoing safety work. For the arrangement to work out satisfactorily, it would be necessary to continue the use of a principle now employed in many states—that of making adjustments in insurance premiums, so that concerns having a heavy casualty record are required to pay high rates, and those having few workers injured each year pay much lower premiums. In this way, the burden is placed where it rightly belongs, on the careless, irresponsible firms; and it is probable that, if the benefits were increased materially, the necessity of meeting these high payments would either force these unprogressive concerns to mend their ways, or drive them out of business.

The extent to which benefits would have to be raised in order to provide adequate compensation and stimulate accident prevention would be determined by careful investigation and experimentation. There is much to be said for continuing a man's wages *in full* during

the period of his total disability, so that he and his family shall not be compelled to lower their standard of living. If, upon recovery, he is unable to perform his old tasks and must accept low-paid work, he might well expect to have his loss made up by the payment of compensation benefits. There is, of course, the danger of malingering to be guarded against; but it is much more difficult to feign accidental injury than industrial illness, and this is a type of abuse that can be prevented very largely by an efficient system of medical examinations. Death benefits should certainly be increased materially, and should be based upon the capitalized earning power of the deceased and the number and ages of his dependents.

If it should appear that increases in benefits such as are here suggested would bear too heavily upon industry, the answer is that one reason—and a most important reason—for making the increase is to render industrial injuries so costly that they will not be tolerated. If 50 to 75 per cent of our industrial accidents can be prevented, as experts firmly believe, and if accident prevention lies within the province of the employer, as it clearly does, then it is high time to bring pressure to bear upon American business men so that they will cease to ignore this vital problem. Doubtless the best antidote for indifference is a heavy addition to the costs of operation of those employers who refuse to turn over a new leaf.[8]

Rehabilitation of the Injured. "Prevention, compensation, and rehabilitation" is the battle cry of those who are warring against industrial accidents. Prevention, of course, would be the best of all possible solutions of the problem. But complete prevention is apparently unattainable, and in its absence there is sore need for compensation and rehabilitation. Of prevention and compensation we have already said enough, but we must not close our discussion without some reference to the possibilities of industrial rehabilitation.

It is socially desirable that the victims of industrial accidents be accorded such treatment as will enable them to resume productive work promptly. In many instances, however, a complete recovery does not mean that the worker is ready for a job, for the seriousness of the injury may preclude the possibility of a return to the old occupation. The loss of a hand, an arm, or an eye may completely incapacitate a worker so far as the performance of his former duties

[8] An increase in benefits, of the type here outlined and for the purposes set forth, is strongly advocated by Professor Bowers.

is concerned. Rehabilitation is defined by law as "the rendering of a physically handicapped person fit to engage in a remunerative occupation." The great need for assistance of this kind is indicated by an estimate of the director of the Federal Board for Vocational Education to the effect that there are some 200,000 persons permanently disabled in the United States annually. Some of these are hopelessly crippled and cannot work again, some are able to resume their old jobs fairly soon, and still others—estimated at some 55,000 persons—need help in getting into employment by means of which they can support themselves. But the number of those actually rehabilitated is only about 10,000 a year.

The work of rehabilitation is carried on by the states in cooperation with the federal government, by authority of the Civilian Vocational Rehabilitation Act of 1920. The states are granted federal aid on the basis of population, each state supplying from its treasury an amount equal to that provided by the federal government, and the task of training workers for new occupations is carried on under the direction of the Federal Board for Vocational Education. Mr. J. C. Wright, former director of the Board, has outlined the work of rehabilitation as consisting of (1) locating the persons who need training, (2) advising with them about the kinds of jobs in which they would be happy and for which they are fitted, (3) training them for the selected jobs, (4) finding openings for them in industrial plants, and (5) following up the cases for six months to two years to make sure that the rehabilitation has been satisfactorily completed. Strangely enough, those who need rehabilitation often have to be urged to accept the assistance which is available without cost. This fact probably accounts in large measure for the limited effectiveness of the work, which at present is reaching only about 20 per cent of those who need aid of this kind. Rehabilitation work will doubtless increase in popularity when it becomes more widely known that most of the men and women who have been rehabilitated are able to earn more after than before they were disabled. The federal Social Security Act recognized the importance of this work by increasing by approximately two million dollars a year (beginning in 1938) the federal appropriations to be used for purposes of rehabilitation of the disabled.

SICKNESS

Sickness is very similar to unemployment and industrial injury in its economic consequences. The man who is without work from any of these three causes is likewise without income and, unless some system of aid has been provided, may gradually sink to the depths of poverty. In an economic sense, sickness and injury are even more serious than unemployment, since they add the burden of medical costs to the worker's regular expenses of maintenance.

The Extent and Cost of Sickness. Our information on the extent of sickness in the United States, like most of our information on conditions of social welfare, is extremely meager. Here again, as in so many instances, we have to fall back upon estimates. But if these estimates come anywhere near the truth, we can no longer afford to ignore this phase of the problem of economic insecurity. The National Health Survey of the United States Public Health Service estimated, from data collected in 1935–36, that "6,000,000 people in the United States are unable to work, attend school, or pursue other activities each day during the winter months on account of illness, injury, or gross physical impairment resulting from disease or illness," that there are 22,000,000 illnesses disabling individuals annually for a week or longer, and that "close to 1¼ billion days are lost annually from work at home or in industry, and from school, through illness disabling for one week or longer." [9] Professor Abraham Epstein, who has written extensively on the subject, says that "from 2,500,000 to 3,000,000 persons are ill in the United States every day." [10] The loss in wages is placed by the National Industrial Conference Board at $250,000,000 a year, and by Professor Irving Fisher at $500,000,000. Dr. Dublin believes that the total loss in current production runs to more than $1,250,000,000 per year, and that another billion dollars must be added to cover medical costs. We may note, finally, the estimate of the late Dr. I. M. Rubinow, who held that "the economic loss resulting from illness is at least five or six times as great as that due to industrial accidents."

The Need for Public Action. In view of these terrific economic losses, not to mention the human suffering involved in such wide-

[9] An *Estimate of the Amount of Disabling Illness in the Country as a Whole*, Washington, United States Public Health Service, Preliminary Reports, Bulletin No. 1, 1938, pp. 1–3.

[10] Abraham Epstein, "Health Insurance—the Next Step," in *The New Republic*, February 17, 1937, p. 35.

spread sickness, it is surprising that we have done so little in this country to remedy the situation. We have had, to be sure, anti-spitting laws and anti-tuberculosis campaigns; health pamphlets issued by insurance companies and health hints written by newspaper columnists; a limited number of public clinics for the poverty-stricken, and free medical service for the employees of a few progressive firms; sick benefits through trade unions, and health insurance provided by a handful of employers. But our attempts to safeguard the average citizen against ill health, and to indemnify him for economic loss when sickness lays hold upon him, have been, on the whole, quite haphazard.

There can be little doubt that our tradition of individualism has been a serious obstacle to the development of a program of health conservation and insurance in the United States. Custom has decreed that whoever can pay must meet his own doctor bills, and, in the absence of ability to pay, either the pride of the needy or the unwillingness of doctors to work without pay has often stood in the way of sick persons getting much-needed medical attention. "Caught between two millstones—loss of wages and unbearably heavy sickness costs—the sick American wage earner first tries to get along with as little medical care as possible. When this can no longer be done, his alternative is private or public charitable medical relief. A compilation of sickness surveys in twelve communities in the United States, made by Dr. Michael M. Davis, disclosed that from 25 to 30 per cent of the relatively serious cases of sickness had no physician's care. In the rich city of Rochester, New York, 39 per cent of the persons suffering from disabling illness had no doctor in attendance. The Committee on the Cost of Medical Care concluded: 'Each year nearly one-half of the individuals in the lowest income group receive no professional medical care or dental attention of any kind, curative or preventive.' "[11]

Cooperative Health Service. In comparatively recent years, an attempt has been made to provide relief through the agency of cooperative systems of health service, enabling a family to provide for its medical needs by paying a stated sum over a specified period of time, say a year. For quite a while, the officials of the American Medical Association were outspoken in their opposition to schemes of this kind, apparently wishing to keep their business relationships with their patients on an individual basis, and to charge for each

[11] *Ibid.*, p. 35.

item of service rendered rather than to make a set annual charge. However, there has been increasing insistence, on the part of both physicians and the public, upon the expansion of cooperative health service. The American Institute of Public Opinion made a survey in 1938, which showed that seven out of ten doctors favored the adoption of a plan which, through regular payments to a health fund, would assure necessary medical and hospital care to an individual or family; and that 53 per cent of the population were willing to pay a satisfactory charge—say, $2.00 a month per person—in order to be certain of having complete medical and hospital care when it was needed.[12]

Another survey, made public in November, 1944, showed that 82 per cent of the persons polled thought that "something should be done to make it easier for people to get medical care when they need it"; and that "68 per cent of the American people favor extending social security to cover doctor and hospital care, while 67 per cent would be willing to pay $3.00 a month if assured complete doctor and hospital care for themselves and their families anytime in the future."[13] Just a year later, President Truman addressed a message to Congress, asking that legislation be passed to establish, among other things, a program for the prepayment (through social security contributions) of medical costs, including medical, dental, hospital, nursing, and laboratory service; and declaring that "by preventing illness, by assuring access to needed community and personal health services, by promoting medical research, and by protecting our people against the loss caused by sickness, we shall strengthen our national health, our national defence, and our national productivity. We shall increase the professional and economic opportunities of our physicians, dentists, and nurses. We shall increase the effectiveness of our hospitals and public health agencies. We shall bring new security to our people."[14]

The Case for Socialized Medicine. Though cooperative health service would be a great advance over the situation that exists today, and would mean better health and longer life for many, it seems evident that many millions of our poorer citizens could not pay even the modest charge proposed in most plans of this kind. For those in the lowest income groups, adequate medical attention

[12] *The New York Times*, June 15, 1938.
[13] *Ibid.*, November 19, 1944.
[14] *Ibid.*, November 20, 1945.

seems to be out of the question unless it is provided without any charge whatsoever. The advocates of socialized medicine argue that, since the public health is scarcely to be regarded as less important than general education, there is no good reason for not socializing our health service as we have socialized our grade-school and high-school education, providing medical advice and treatment and free hospitalization for all who need them, at the expense of the state. They even insist that, far from being a costly piece of social engineering, a health program of this sort would be a great money-saving venture, cutting down materially the loss in total national income which we now suffer because of sickness. That such a program, properly carried out, would reduce the death toll is indicated by the statement of Dr. Russell L. Cecil, of the Medical Society of New York State, to the effect that "25,000 to 30,000 lives might be saved annually in this country if inexpensive or free pneumonia serum were generally and quickly available."

In March, 1946, the Labor Government of Britain introduced into Parliament a national health program which proposed that government-financed medical and dental care be given to "all the 40,000,000 people in England and Wales." This bill provided for the public ownership of all hospitals except those giving instruction to doctors, and free hospitalization for all patients who need it; the establishment of new public health centers for hospital, clinical, dental, and specialist services, with free treatment and medicine; and eye examinations and the provision of glasses at no cost.[15] This program, which is scheduled to go into effect in 1948, is quite definitely *socialized medicine* (since it will provide for the needs of *all* citizens without payment), in contrast to the plan proposed for the United States by President Truman, who repeatedly stated that he was proposing *not* socialized medicine, but a program which would be paid for "through expansion of our existing compulsory social insurance system." The cost of the British program, estimated at $608,-000,000 annually, will be shared by national and local governments in the ratio of about five to one. However, the national government's payment will come out of the national social security fund, so that the plan, in its financial aspects, is not strikingly different from President Truman's. It may be added that in Britain "all patients will be free to choose their own doctors, even their family doctors if [the latter] join the service; or, if they prefer to pay,

[15] Philadelphia *Evening Bulletin*, March 22, 1946.

there will be no ban on private practitioners and they can go on as before."[16] Reports from England are to the effect that "the bill, in its general outlines, has received universal approval, since the Conservatives and Laborites alike agree on the principle of comprehensive medical services free to everyone."[16]

Wage Payments During Illness. Leaving, now, the question of whether medical and hospital care are to be provided individually, cooperatively, or socially, we shall examine briefly the problem of indemnifying the workers for the loss of income resulting from the inability to perform their daily tasks. There has been much argument as to whether this should be done at all, and if so, to what extent and at whose expense. An examination of the situation seems to indicate that sickness benefits should and must be paid to ailing workers, if we are to have a system of health preservation worthy of the name. Industrial workers usually feel that they cannot afford to quit their jobs on account of illness as long as they are able to "keep going." As a consequence, we have many workers in our stores, offices, and factories who should be at home under a physician's care; and the result is that "common colds," influenza, and other diseases take a far heavier toll than need be.

Until we make it easy for the sick worker to stay in bed, we have not adequately protected those who will have to work with him and ride beside him in crowded street cars if he tries to carry on. We believe, therefore, that a sound public health program must include provision for the payment of sickness benefits that will permit workers to get rest and treatment in the early stages of their illness. The possibility of malingering must not be allowed to interfere with this essential feature of health conservation, for there are ways of guarding against it, and even at its worst it is far less expensive than epidemics. President Truman's proposal for health service recognized the need for provision against the loss of wages through sickness and disability, in these words: "A comprehensive health program must include the payment of benefits to replace at least part of the earnings that are lost during the period of sickness and long-term disability. This protection can be readily and conveniently provided through expansion of our present social insurance system, with appropriate adjustment of premiums."[17]

Who Shall Pay the Bill? Many persons will consider it entirely fitting and proper for the worker to contribute to the health insur-

[16] *The New York Times,* March 22, 1946. [17] *Ibid.,* November 20, 1945.

ance fund, but some may object to the employer being taxed (as he would be under the Truman plan) for this purpose. So far as the inability to work is caused by occupational disease, the employer can rightly be charged with being largely responsible for the loss of time, just as in the case of industrial injuries; but only a part, and probably a minor part, of the illness of workers is attributable to the neglect of employers to provide sanitary working conditions. If the employer's contribution to health insurance requires justification, it is doubtless best to place it on the ground of social expediency. Since the worker is to pay something, the most convenient and least expensive method of collection is to have the employer hold back a specified amount of his wages. But since the worker cannot afford to meet the whole expense, it is expedient from the social point of view to let the employer also make a contribution. In most instances at least, this contribution will enter into the costs of production, and therefore into the selling price. In this way the employer will usually find it possible to shift the burden of health insurance to the ultimate consumers of his product. It should be observed that President Truman's message to Congress implied that a part of the expense might have to be met from general revenues.

Health insurance, it may be said once more, must be *compulsory* if it is to benefit those who need it most. With workers interpreting too literally the Biblical precept, "Take no thought for the morrow," and with employers none too willing to assume social responsibilities that involve money payments, it will not do to entrust so vital a measure as health insurance to the vagaries of voluntary acceptance. Its adoption, like that of workmen's compensation and other forms of social insurance, must be enforced by the state.

Old Age

For the worker who escapes or manages to survive unemployment, industrial injury, and loss of time through sickness, old age lies in wait at the end of the trail. How ill equipped the average worker is to cope with this last great bearer of economic insecurity may be judged by reference to the figures we have already given relating to average yearly wages and minimum yearly expenditures in the United States. The prospect of living to "a ripe old age" is not so alluring when it is realized that two out of every three persons who attain the age of sixty-five in this country are from that time forth dependent upon others for support.

The Extent of Old Age Dependency. It is estimated by the National Industrial Conference Board that 6.9 per cent of the population of the United States, or nearly 10,000,000 persons, were sixty-five years of age or over in 1940, and that the percentage will be 10.2 by 1970.[18] About two-thirds of these persons are dependent upon public, private, or family aid. Nearly 70 per cent rely upon their children or other relatives for support, the others being cared for through private and public relief, in and out of institutions.

"Old Age" in Middle Life. In referring to persons sixty-five years of age and over, we have not meant to imply that this is necessarily the point at which "old age" sets in. The ability to render useful service is not restricted to youth and middle age. The old saying that a man is as young as he feels has much truth in it, for we can find abundant examples of men who are young at seventy-five and others who are worn out at forty. Many persons are self-supporting long after they have reached sixty-five; but it is unquestionably true that, as the years accumulate, the average worker finds it increasingly difficult to secure and hold fast to a remunerative job.

The situation has become particularly acute of recent years, for there has developed, on the part of business enterprisers, a growing reluctance to take on new workers who are more than forty or forty-five years of age. Indeed, it is the policy of some concerns to limit the hiring age to thirty-five years in the case of unskilled labor. Our census figures show that in agriculture, in small businesses, in professions, and in public service, this discrimination against the older workers has not been exercised extensively, but in the great extractive and manufacturing industries the age limit has undoubtedly been declining steadily. "At the Highland Park Plant of the Ford Company," wrote Dr. Harry W. Laidler some years ago, "about three-fourths of the men were found to be under forty. It is practically impossible for a man over forty to get a job there, while men who have reached that age find difficulty in holding their jobs. In a recent investigation in certain steel mills, it was found that the average age of the steel workers was not far from thirty." The adoption of specific age limits is usually attributed to the lower wages of younger workers; their greater speed, endurance, and adaptability; the higher cost of group insurance when older workers are included; the adoption of non-contributory pension systems;

[18] *The Economic Almanac, 1945–46,* New York, National Industrial Conference Board, 1945, p. 1.

and the cost of workmen's compensation. (Of course, the manpower shortage of World War II changed this situation temporarily.)

Despite the current practice of turning workers loose at an age that used to be thought the prime of life, the measures that have been taken to care for old age dependency have seldom provided for payments before sixty-five in the case of men, and sixty in the case of women. These were found to be the usual ages of "retirement" in a study of industrial pensions conducted by the National Industrial Conference Board.[19] This means in reality that those able to hold their jobs until they attained the ages mentioned would then begin to draw pensions, other workers being dismissed in the meantime as they appeared to their employers to be liabilities rather than assets. The public pension systems thus far inaugurated in the United States stipulate that payments shall not begin before the age of sixty-five, and in some instances not until the dependent has reached seventy years of age. If industrial workers are to be "scrapped" at forty, forty-five, or fifty, a pension that does not provide payments before sixty-five is clearly deficient. Unless the present tendency to discriminate against the older workers is checked, it will be necessary to revise our working concept of old age, and to define it as that age at which a worker is no longer wanted by industry and is therefore unable to secure even reasonably steady employment.

Savings as Security Against Old Age. It is hard to dislodge from the minds of successful business men the notion that whoever is industrious, sober, and thrifty can himself provide against the various forms of economic insecurity. "When businessmen think of security for their businesses against the day of misfortune, they think in terms of surpluses," said a former president of the National Association of Manufacturers in a public speech. "The building up of corporate surpluses . . . is generally recognized as not only a sound principle of business, but a saving principle, and I see no reason why it is not as applicable and essential to the economic program of an individual as to that of a corporation. I cannot conceive of security of enduring character apart from the practice of thrift and energetic exercise of individual responsibility."[20] This

[19] *Elements of Industrial Pension Plans,* New York, National Industrial Conference Board, 1931, p. 20.

[20] John E. Edgerton, "Principles of Economic Security," in *Annals of the American Academy of Political and Social Science,* March, 1931, p. 76.

cheerful philosophy assumes that there are times in the life of every man when his income is greater than his necessary expenses; otherwise, he would experience considerable difficulty accumulating a surplus. But studies of wages and family budgets show the weakness of this fundamental assumption. If, as we have seen, the *average* wage in the United States is barely large enough to buy a minimum standard of living, it is idle to talk of setting aside surpluses to meet the emergencies of unemployment, accidents, sickness, and old age.

We are not here suggesting that it is impossible for any wage earners to save. The two and a half billion dollars in the "thrift accounts" of the Postal Savings System are evidence to the contrary. The unknown volume of workingmen's deposits in savings accounts is further proof that very modest surpluses can be, and are, built up, at least temporarily, by the more fortunate wage earners. But the futility of asking wage earners in general to guard against economic insecurity by adopting the corporation plan of accumulating surpluses "out of their earnings during the days of profitable operation" becomes apparent when we recall that it is not unusual for one-third of the wage earners in the United States to receive only from $500 to $1000 a year each, while the incomes of another third fall between $1000 and $1500.

Trade Union and Industrial Pensions. Trade unions and individual business concerns have done something to relieve old age dependency by arranging to pension their members and employees, respectively. According to officials of the American Federation of Labor, nine international unions and six local unions are paying $4,000,000 a year to about 11,500 pensioners. Figures from the United States Pauper Census indicate that 80,000 persons are receiving industrial pensions, with total payments estimated at from $50,000,000 to $60,000,000 annually. Through these two types of relief, therefore, about 90,000 dependents receive aid, amounting on the average to $350 a year for the trade unionists, and from $625 to $750 annually for the industrial pensioners.

Pensions for Public Employees. A much larger number of old age dependents are taken care of under the pension systems provided for certain employees of the federal, state, and municipal governments. Civil service employees of the United States government contribute 5 per cent of their basic salaries to a pension fund from which, at the age of sixty-two, they draw annual benefits

that may go as high as $1200 or even higher. They are also protected against total disability prior to the age of retirement. In 1944, payments to the amount of approximately $86,000,000 were made to some 85,000 federal civil service pensioners; and $138,000,000 was paid in benefits to 164,000 retired workers under the provisions of the Railroad Retirement Act.

Public-school teachers form the largest group of state and municipal servants now enjoying retirement privileges, though pensions have also been provided by these governmental units for certain other classes of workers. It is estimated that more than 800,000 public-school teachers come under the protection of state or municipal pension systems, and almost as many state and local employees of other types have protection under pension plans. Other pensioners in the field of public or semi-public service are war veterans, in certain classifications, to whom payments are made by the United States government; college teachers, who come under the retirement provisions of the Carnegie Foundation, or the annuity system of the Teachers' Insurance and Annuity Association; and superannuated preachers and their dependents, who are provided for by the church boards of the several denominations.

The Case for Industrial Pensions. The scattered data presented here are unsatisfactory in many respects, but they serve at least to show that federal, state, and municipal governments have recognized more fully than business enterprisers an obligation toward employees who are no longer capable of earning a living. This does not mean that employers are oblivious to the merits of industrial pensions, or that they have done nothing toward putting pension plans into operation. We have noted the fact that 80,000 retired workers are now drawing industrial pensions; and it has been estimated by Mr. A. D. Cloud, an authority on the subject, that probably 5,000,000 workers are covered by *formal* pension systems of the United States, besides those coming under *informal* plans. It seems probable, then, that some 20 per cent of all persons gainfully employed in industry are in some measure protected against old age dependency by the prospect of receiving pensions. But the protection is not complete, since only 30 per cent of the pension systems are *contractual*, comprising definite obligations to the performance of which the employer is legally bound. In many cases, whatever "rights" the worker may have are those of a *pensioner* and not of an *employee.* Usually the employer attempts to word the

agreement in such manner that he is unhampered in granting or denying a pension, the worker being uncertain whether he will receive any benefits from the system until he is actually placed on the pension list. However, the employer's "disclaimer" is often declared invalid in the event of litigation.

There is no reason to suppose that many employers would fail to live up to the spirit of any pension system which they had voluntarily adopted. Indeed, the payment of pensions is coming to be regarded by our largest industries as a business proposition, and not an act of philanthropy. There has until recently been no legal obligation to adopt a pension system for superannuated workers, but the truth is that these aged workers have been recognized by enlightened concerns as "drags upon production," and many enterprisers have believed it too costly to keep them at their accustomed tasks. Of course they might have been discharged, but the thought of "firing" employees who have grown old in service is repugnant to most employers, and, moreover, this sort of practice tends to break the morale of those who remain. But many concrete advantages accrue to the employer who adopts a pension system, not the least of which is a reduction in labor turnover. It is probable, indeed, that a pension plan *can* pay for itself by increasing the continuity of service.

The Need for Compulsory Pensions. Despite the benefits that a business enjoys through the operation of an industrial pension plan, the adoption or rejection of a pension system cannot safely be left to the individual enterpriser. In this, as in all types of social insurance, compulsion is an essential feature; for if the proposed measure for relief is put on a voluntary basis, there will inevitably be unprogressive employers who will ignore it completely. This lesson was long since learned by the nations of Europe, to whom social insurance of various kinds is now an old story. No important country has voluntary old age insurance today; but there are at least twenty-five countries operating under compulsory systems, with pensions paid from general funds to which employers and employees, and sometimes the state as well, contribute.

Old Age Annuities Under the Social Security Act of 1935. The Social Security Act (as amended in August, 1939) provides for a system of annuities to be paid to workers over sixty-five years of age who have aided in building up a fund by making periodic payments in their earlier years. It also provides payments for certain

dependents and survivors of such workers. The basic annuity plan consists of a contractual arrangement between the federal government and the worker who contributes to the fund. The annuity which the worker receives in his old age is his by right and not by grant. It is his regardless of whether he has or has not other sources of income; and it is his to spend, save, or give away, as he may choose.

This annuity scheme is a federal and not a state plan, and applies to all workers in certain trades throughout the United States. It is financed by taxes or contributions made by both employers and employees, dating from January 1, 1937. This annuity plan, like the unemployment insurance arrangement provided under the Social Security Act, does not apply to agricultural workers, domestic servants in private homes, officers and crews engaged in shipping in the United States waters, and employees of non-profit-making organizations. Individual enterprisers, such as self-employed farmers, professional men, and small shopkeepers, are not covered by the plan; nor are the 24,000,000 housewives or the millions of others who do not rate as "gainful workers." Business concerns that have had their own private pension systems in the past have in many cases coordinated them with the terms of the Social Security Act, instead of abandoning the private plans. Indeed, the number of private pension plans has *increased* since 1935. In July, 1945, 1,285,000 pensioners were drawing old age and survivor benefits, and the Social Security Board estimates that between 3½ and 5 million aged persons will be receiving monthly benefits by 1960. Some 44,700,000 workers and dependents are now covered by this old age annuity system. In 1944, slightly more than a billion dollars was disbursed in retirement, disability, and survivor benefits under the contributory provisions of the Social Security Act.

Both employers and employees were required to contribute to the annuity fund 1 per cent of the first $3000 of wages or salaries received from 1937 to 1942, inclusive, with increases in this percentage from 1943 to 1949, when the tax will have reached 3 per cent each for employer and employee,[21] or a total of 6 per cent of the taxable portion of the latter's earnings. As in the case of unemployment insurance, the payments made by both employers and employees will doubtless be shifted, in large part, to the ultimate

[21] The tax was actually "frozen" at 1 per cent in 1943, instead of being raised as originally planned, and was still set at that figure in 1946.

consumer, appearing in the form of higher prices. Up to this time, the receipts have been considerably greater than the disbursements, so that the Federal Old-Age and Survivors Insurance Trust Fund, as it is called, now amounts to $6,615,000,000. But later the disbursements may exceed the receipts, so that the Trust Fund may eventually be exhausted, making it necessary to finance benefit payments in part from current taxation.

The benefit payments received by the workers vary from $10 to $85 a month, depending upon the amount of the individual worker's average monthly wage up to $250 a month. The basis of calculation is the worker's "primary benefit," which is found by taking 40 per cent of the first $50 of his average monthly wage, adding 10 per cent of the balance up to $250, and then adding 1 per cent of this sum for each year since 1937 (when the law became effective) in which he received $200 or more in wages. Let us take the case of a worker in a covered occupation, whose average monthly wage since 1937 has been $200 and who reaches the age of sixty-five in 1947. His primary benefit—the amount of his monthly old age benefit—is computed as follows: Forty per cent of $50, or $20; plus 10 per cent of $150, or $15; plus 1 per cent of the total, $35, for each of ten years, or $3.50; giving this worker after 1947 a total benefit of $38.50 a month, which he will receive as long as he lives. The payment of benefits began in 1940 for insured workers who reached the age of sixty-five in that year.

Payments for Workers' Dependents and Survivors. Under the 1939 amendment of the Social Security Act, provision was made for monthly payments to certain dependents of the retired worker or for specified survivors upon his death. These payments are based on the worker's primary benefit, which is the *personal* annuity he receives regardless of any family responsibilities he may have. However, if he is married, his wife (if she is sixty-five years of age) is entitled to an additional payment amounting to one-half the primary benefit; and each child under sixteen (or under eighteen, if in school) is granted a similar payment. This would mean, for the hypothetical worker whose primary benefit was calculated in the preceding paragraph, a total family income of $57.75 for himself and wife of sixty-five or over; or a total of $77.00 if they had a child of seventeen or eighteen still attending school. But it would not mean $96.25 if they had two such children; for the law limits a family income to twice the amount of the primary benefit, or 80

per cent of the worker's average monthly wage, or $85.00, whichever is the least.

The payment for dependent children ends at age eighteen, but the wife's payment continues as long as she and her husband both live. If she survives him, her payment is increased 50 per cent—that is, it becomes three-fourths of the primary benefit instead of only one-half. If a worker's wife is under sixty-five at the time of his retirement, she does not draw benefits until she reaches that age; she then receives one-half the primary benefit if her husband is living, and three-fourths if he has died. Dependent parents of sixty-five who outlive a worker are entitled to survivors' payments if the insured has left no widow or young child. The benefit in this case is one-half the primary benefit for each dependent parent.

In December, 1943, the average monthly benefit paid to retired male workers was $23.60; to retired female workers, $19.00; to wives of retired workers, $13.60; to children, $12.20; to aged widows, $20.20; to widows with one child, $34.30; and to dependent parents, $13.20.

Federal-State Old Age Pensions. This system of compulsory annuities relieves many of our workers of the fear of a wholly penniless old age. It leaves but meagerly protected, however, those workers whose average monthly incomes have been very low; and overlooks entirely, as we have seen, the workers in many occupations whose daily tasks do not bring them under the provisions of the Social Security Act. Such persons are entitled to support in their declining years, as we have acknowledged through the maintenance of almshouses or poorhouses, which now, happily, are giving way to more humane and less costly methods of caring for the aged.

For a good many years, prior to 1935, about a dozen of our states provided old age pensions for their citizens. These payments were not annuities, such as we have described in the preceding section, but allowances for old persons with no other source of income. In general, the age at which payments began was sixty-five to seventy; the *maximum* allowances of the several states ran from $250 to $360 a year; and there were residence requirements ranging from one to fifteen years of residence in the country, and from ten to fifteen years in the state.

In an attempt to extend old age pensions to the destitute aged throughout the country, the framers of the Social Security Act of

1935 included in its provisions the payment by the federal government of one-half of payments made by any state to its needy aged, up to the total of $30 a month, or a maximum contribution of $15 a month by the federal government for a single pension; and the amendment to this Act in 1939 raised the maximum federal contribution to $20. This means at least some assistance to the indigent aged in the states which accept the terms offered by this section of the Act, and all the states have done so. However, the needy do not always receive as much as $40 a month, for some states have decided upon smaller pensions. The grants in 1945 varied from a high of $47.42 in California to a low of $11.58 in Kentucky, with an average of $30.69 for the country as a whole. In 1944, approximately two million persons were paid some $693,000,000 in old age assistance of this kind.

These payments are clearly in the nature of charity, being paid avowedly to destitute persons only, who are required to prove that they have no other source of income. This seems to us to be a disadvantage. We believe that federal provision should be made for either an annuity or an old age allowance for every person of sixty-five or over, whose total income from other sources does not exceed a stated amount, say $400 a year. We propose, in other words, that everyone in the country shall enjoy the protection of a guaranteed old age income. The aged person would collect, then, from the annuity plan to which he has contributed, or from the old age allowance plan, but not from both. The public allowance for those without annuity provision should be of such size as to insure at least a minimum of comfortable subsistence, and should vary with changes in the price level. We believe that dependence upon old age provision of this kind should not involve a loss of self-respect on the part of the recipients, and we see no reason for any greater stigma attaching to the acceptance of an industrial annuity or public allowance than now attaches to the acceptance of free public school training or police protection.

We referred, a little while back, to the costliness of caring for dependents in almshouses and similar institutions. Old age pensions are more economical, largely because the operation of poorhouses entails very high costs of administration, sometimes amounting to more than 50 per cent of the total appropriations for these institutions. After eight months' experience with old age pensions in Pennsylvania, the commission in charge reported that the total cost

of the pension system in that state would not exceed $5,000,000, and added that for that sum "we would be able to take care of more than three times the number of people now supported in our almshouses, upon which institutions we are now making an annual cash expenditure of approximately $6,000,000." Through the adoption of a comprehensive system of old age pensions, we have the opportunity not only to repay a debt, long since overdue, to the aged men and women whose labors have swelled the incomes of the well-to-do, but also to handle humanely and economically a problem which has been dealt with largely in a barbarous and wasteful fashion.

Further Federal-State Aid to the Needy. The amended Social Security Act has provided for further assistance for the needy. Blind persons who cannot support themselves are cared for under a program which is very similar to the federal-state old age pension plan that we have described. The federal government contributes as much as the state toward the benefit payment of each blind dependent, with a maximum of $20 a month for the federal half of the total benefit. Benefits of this kind to the blind amounted in 1944 to $25,000,000. The government also makes contributions equal to those of the state, to be used in caring for needy children who are living with a parent or other close relative. The maximum total payment for the first dependent child is $18 a month, and $12 a month each for additional dependent children in the same house. Of these amounts, the federal government pays $9 and $6, respectively. In 1944, payments for dependent children amounted to $135,000,000.

Conclusion. The limitations of space have made it impossible for us to give to the problem of economic insecurity the thorough examination which, by virtue of its social consequences, it deserves. We have looked into the matter sufficiently, however, to understand that the problem consists of maladjustments over which the worker has no control—maladjustments which, nevertheless, cut off his income and thus deprive him of purchasing power that he must somehow secure if he and his dependents are to have the necessities of life.

We have proposed that whatever aid is required shall be provided, either directly or indirectly, by the community of which the worker is a member. In this country, the "community" will in some cases be the state and in other cases the nation. The means by which aid may best be rendered appears to be social insurance of appro-

priate types. We believe that premiums covering insurance for unemployment, industrial accidents, sickness, and old age are legitimate costs of production, so far as these forms of maladjustment are unavoidable. The consuming public should expect to pay, and be willing to pay, prices that include these necessary costs; and it is inevitable that, in the long run, irreducible costs for social insurance will enter into the selling price of any good into the competitive production of which labor protected by compulsory social insurance has entered. Consequently, such insurance will not, in a given industry, impose a burden upon those concerns which succeed in reducing unemployment to a minimum, safeguarding their employees against accidents and sickness, and so conserving the strength and skill of their workers as to make it unnecessary to pension employees until they have reached an advanced age. It is only those firms that fail to duplicate the performance of such socially-minded concerns that, by reason of high insurance premiums, will be forced to bear any part of the burden of social insurance; and, as we have suggested, this penalty of high costs will provide the incentive to lessen the maladjustments that give rise to these high costs.

It is probable that there will always be some members of society who, because of physical or mental defects, cannot be expected to support themselves. Unfortunates of these kinds will have to be cared for at the public expense, unless they have friends or relatives who are able to look after them adequately. But as for the great mass of industrial workers who are anxious to be self-supporting, we believe that, in general, it is both fair and feasible that the industries with which the workers ally themselves should be made responsible for providing economic security. Once a worker has attached himself to an industry, this industry should be made to contribute to a fund from which he will receive an income when he is not working, just so long as his idleness is not voluntary. In times of unemployment, he should receive unemployment benefits; if incapacitated by accident or sickness, he should have "compensation" or "sick pay"; and when, by reason of the infirmities of old age, he is not longer able to perform his daily tasks, he should have either an annuity or old age assistance provided by the state.

Ordinarily, the cost of industrial security may properly be levied against the industry that is involved, but in certain instances, as we have already suggested, it may be better for the state or federal government to make the payments directly to those entitled to them,

from funds collected through steeply graduated taxation. In either case, we believe firmly that the community should definitely accept the responsibility for providing, directly or indirectly, a substantial income to all members of society who are willing to work but who, because of circumstances wholly beyond their control, are unable to command the purchasing power needed to buy the necessities of life.

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1. It is said that confusion in the use of the words "accident" and "injury" leads us to give less attention to *accidents of all kinds* than they deserve. Explain.
2. Distinguish carefully between "direct" and "indirect" costs of injuries, and give some idea of the relative monetary significance of the two.
3. It has long been believed that most industrial injuries are caused by the failure to provide safe physical conditions of work. Argue that this belief is or is not sound.
4. How might the cause of accident prevention be advanced through modifications of the benefits paid to injured workmen under the provisions of the workmen's compensation laws?
5. "It would pay society in dollars and cents to provide free medical and hospital service for all who need it, and to require employers to pay sick benefits to ailing workers." Examine critically the facts upon which this statement is based, and decide whether they are or are not adequate. In other words, determine whether the above conclusion is warranted by the facts that are presented.
6. What is the attitude of the medical profession in general toward socialized medicine?
7. "Sickness benefits should and must be paid to ailing workers." Argue pro and con.
8. What relationship, if any, do you see between *"old age" in middle life* and *technological unemployment?*
9. To what extent does dependent old age exist in the United States at the present time, and what measures have been taken to care for the destitute?
10. Discuss the possibility of handling the problem of old age maintenance by means of savings accumulated during working years.
11. The champions of social insurance usually insist that it must be of the *compulsory* and not of the *voluntary* type. What grounds are there for believing that voluntary social insurance would not meet the needs of the situation?
12. Outline the old age annuity program which was provided for in the amended Social Security Act.
13. Discuss the manner in which, under the Act, grants may be made to dependents or survivors of an insured worker.

14. In what respects do federal-state old age pensions differ from federal old age annuities? Why is it thought desirable to have two types of old age provision?
15. "Too much is being expected of government. Louder and louder the voice of the demagogue is sounding through our land, and bolder are becoming the forces of resistance to orderly procedure. The number of those who openly confess their communistic dreams is still relatively small, even though it has been growing in this season of discontent. . . . From such conditions and sources there naturally come, and will probably continue to come until the conditions have passed, proposals for public unemployment insurance and other schemes in the name of charity to subtract from private responsibility and add to that of the government."

    In the light of this statement, criticize the proposals for social security that were made in the present chapter.
16. Unemployment, industrial injury, sickness, and old age have been dealt with as phases of the general problem of economic insecurity. What have these four items in common that makes it possible to consider them as parts of the one broad problem?

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PROBLEMS OF FINANCE

7. Commercial Banking

Credit is a term in very common use today, but one which has a variety of meanings. In general, credit may be said to mean the exchange of present goods for an equivalent which someone undertakes to furnish within a stated period of time. Our definition of credit in general must be couched in broad terms, because it must be made applicable to many different operations, ranging from the pledge of a saxophone at a pawnshop or the purchase of groceries to be paid for after a short time, to the sale of many millions of dollars' worth of bonds for the purpose of adding to the capital equipment of a railroad. In connection with banking, however, "credit" is the word used to refer to loans made by or through banks to individual business men or companies.

Commercial and Investment Credit. Credit, as extended through the banks, may be divided into two classes, investment and commercial credit. These two types of credit may be distinguished on the basis of three criteria: (1) the use to which the funds are put, (2) the length of time for which the credit is extended, and (3) the amount of credit that is granted in a specific instance. Investment credit consists of long-term loans, amounting to large sums, and made for the purpose of acquiring fixed capital. The availability of the future equivalent which is expected by those who, in the last analysis, furnish this type of credit depends as a rule upon an enhanced productivity on the part of the business that makes use of the investment credit in question; that is, the investment credit must be used productively if the loan and interest on it are to be paid when due. Commercial credit, on the other hand, consists of loans of relatively small amounts, extended for short periods of time, and used for supplying working capital. The line of demarcation between investment and commercial credit is not, however, so sharp and clear cut as might appear from this brief description. In reality, the one shades into the other gradually and the connection between

them is often very close. Nevertheless, we may in general take commercial credit to mean loans for a duration of 120 days or less, which will tend to be liquidated through the sale of existing goods or goods which are about ready for sale.

The statement that we live today in an exchange economy is a commonplace of economics. Very few persons produce commodities and services exclusively for themselves. Each individual is a specialist who as a rule performs only a single economic function, and relies upon the exchange process to enable him to obtain the many economic goods which he desires. Barter, or the direct exchange of commodities and services for commodities and services, would be extremely cumbersome and would be attended by well-nigh insuperable difficulties in the present stage of our economic development. Exchange is therefore carried on indirectly, through the use of what is called a medium of exchange. Actual money is still of some importance as a medium of exchange, but for this purpose it is now overshadowed by credit instruments, for it has been estimated that about 90 per cent of business of the United States is carried on through the use of credit instruments such as checks and other drafts.

The Need for Commercial Credit. In the operation of our modern economic system, business men and companies continually find themselves in possession of certain special forms of purchasing power, or claims upon the wealth of the community. These may, for example, take the form of goods finished but unsold, or goods sold but not paid for. In time, through the process of exchange, payment for their goods will be received by these business men and companies. In the meantime, however, the smooth, efficient operation of business demands that further raw materials be purchased, that wages be paid, and that the other regular expenses of business operation be met when due.

In these situations, commercial banks are able to render a great service to business men. By means of short-term loans, these banks substitute their purchasing power of general acceptability (money, or deposits subject to check) for the purchasing power of limited acceptability (goods, notes, or drafts) which is possessed by the business men and firms. In this way these business organizations are able to command at once the commodities and services which they require, and are expected later on to pay their debts to the banks, with interest. From the point of view of individual business con-

cerns, loans are granted and credit is extended from time to time. From the point of view of the country as a whole, an enormous volume of commercial credit is constantly in use, which provides through the use of credit instruments a very important part of the mechanism of exchange.

The Problem of Commercial Banking. Briefly stated, the problem of commercial banking is to attain elasticity of currency and credit while providing the highest possible degree of safety for bank depositors. Perfect elasticity is unattainable unless the following three conditions are met: First, the amount of currency and commercial credit in use must be able to expand and contract. Second, the expansion and contraction of currency and commercial credit must be coordinated, *in point of time*, with the changing needs of business and economic activity in general. Finally, the *extent* of expansion and contraction must also be coordinated with these changing needs.

Under these conditions, money and commercial credit will be able to perform their legitimate function of facilitating the operation of economic activity. They will not be issued in ways and amounts that will raise general prices, stimulate business activity, increase profits, reduce real wages and labor's purchasing power, lead to overinvestment in plant and equipment, and otherwise bring about conditions which will later lead inevitably to business depression; nor will they be decreased so sharply as to precipitate business crisis, liquidation, and depression. Money and commercial credit are legitimate devices for avoiding the inconveniences of barter, and for facilitating business operations. But their issuance should not be allowed to affect the volume of these operations, or to cause instability in economic activities.

The Problem of Elasticity

Inelasticity Under the National Banking System. Before the adoption of the Federal Reserve System, commercial banking in this country failed to provide an adequate measure of elasticity and safety. The principal form of currency in use under the National Banking System, the national bank note, could not be expanded or contracted readily in response to business needs, because these notes could be issued only on the basis of a 100 per cent reserve in the form of certain government bonds, the amount of which did not increase or decrease with changes in business activity. Even more

important was the fact that commercial credit could be extended by the banks only up to the amount for which they held the legal minimum reserves. Facilities were lacking whereby banks could rediscount commercial paper received from their customers and put themselves in a position to extend further commercial credit to their customers. The result was, to repeat, an inelastic system of currency and commercial credit, and yet one, withal, which was not adequately safeguarded.

Federal Reserve Notes. Under the Federal Reserve System, which began to operate in 1914, a new form of currency, called the Federal Reserve note, came into use. This is our most important type of paper money today, and one that may be expanded or contracted in response to business needs. Expansion and contraction are secured by the provision that the usual security for Federal Reserve notes, aside from a minimum gold certificate reserve of 25 per cent, shall be commercial paper—that is, short-term promissory notes and drafts which represent actual business transactions. Whenever business is very active, banks extend large amounts of commercial credit to business men, and have in their possession correspondingly large quantities of commercial paper which can be used as a basis for the issuance of Federal Reserve notes as long as the Reserve banks retain the necessary gold certificate reserves. On the other hand, when business is dull, loans tend to be paid off faster than new loans are made, so that there is a decline in the quantity of commercial paper eligible for use as security for Federal Reserve notes. Thus, the notes expand and contract with business needs.

The notes are issued through the Federal Reserve banks, and it is these banks also that must keep the minimum gold certificate reserve and hold the eligible commercial paper brought in by the member banks to be rediscounted and used as the basis for note issue. To be eligible for these purposes, commercial paper must represent actual industrial, commercial, or agricultural transactions, and must be endorsed by a member bank. The maximum maturity of commercial paper at the time of rediscount is ninety days, except in the case of agricultural paper, which may be for nine months.

Commercial Credit. The large reserves which are accumulated under the Federal Reserve System may, however, be used more effectively as the basis for a great superstructure of commercial credit than as part security for the issuance of Federal Reserve notes.

Since by far the greater part of the business of this country is carried on through the use of credit and credit instruments and not through the use of money, a tremendous volume of commercial credit may be extended and utilized without any great amount of money being used. Consequently, unless a member bank is in need of money when it takes eligible commercial paper to the Reserve bank to be rediscounted, it is very likely to leave the proceeds of the loan on deposit at the Reserve bank, using these proceeds as a legal reserve against the deposits created by the member bank. Upon the basis of this new reserve, then, the member bank may issue commercial credit to business men up to several times the amount of the proceeds of the rediscounting. In addition to the rediscounted paper, the Federal Reserve bank must hold a 25 per cent reserve in gold certificates behind the reserves of the member banks.

The Control of Money and Credit. Money and commercial credit have not been perfectly elastic under the Federal Reserve System, for only two of the essential conditions of elasticity have been met. In violation of the third condition, the extent of expansion and contraction has not been closely coordinated with the changing needs of business. The movements of the general price level and the violent fluctuations in the volume of economic activity which have occurred since 1913 indicate a tendency for the total volume of money and credit to become overexpanded in some periods and overcontracted in others. Despite the powers vested in the System for credit control, the issuance and withdrawal of money and credit have sometimes been allowed to stimulate business artificially, and at other times have made for depression. In other words, money and credit have not been confined to their legitimate neutral rôle of facilitating exchange. These unhappy results are attributable in part to a lack of sufficient authority, and in part to conditions which are inherent in the administration of any system of credit control.

The Control of Rediscount Rates. One of the powers originally granted the Federal Reserve System for controlling money and credit was authority to raise and lower the rediscount rate. When an undue expansion of credit seems imminent, the Reserve banks can raise their rediscount rates, with the approval of the Federal Reserve Board (now the Board of Governors of the Federal Reserve System). Such increases mean, in effect, an increase in the prices which member banks have to pay for additional money or

credit—that is, for loans extended to the member banks on the basis of eligible commercial paper endorsed by them and pledged with the Federal Reserve banks. The results which are expected to follow changes in rediscount rates are quite clear in theory. Increases in rates make it more expensive than formerly for member banks to obtain credit from Reserve banks. It should follow that the member banks will charge their customers higher rates for additional commercial credit and that the customers will consequently limit their new loans, and extensions of old loans, to amounts which are absolutely essential. When this occurs, the expansion of credit will be checked. Similarly, lowering the rediscount rates when business is slack is supposed to make it easier for member banks and their customers to borrow, and thus encourages them to increase their loans.

The Effectiveness of Changes in Rediscount Rates. In actual practice, however, raising and lowering the rediscount rates has not been an effective device for controlling the expansion and contraction of money and commercial credit. In the first place, a considerable expansion of credit sometimes gets under way without recourse to rediscounting by member banks, because they have large reserves idle at the beginning of a period of active business. In the second place, when a bank rediscounts in order to increase its reserves with a Federal Reserve bank, it acquires a greater lending power than appears on the surface. If a bank adds $1000 to its reserve by rediscounting, it is enabled to lend much more than that sum to business men in the form of demand deposits, even if other member banks are not doing the same thing. While opinions differ on this point, it is probable that the member bank could lend at least $1500 in demand deposits to business men on the strength of an increase of $1000 in its legal reserves. This is possible because loans in the form of demand deposits are not always entirely checked out by the borrowers, and when checks are drawn against such deposits, they are often redeposited in the same bank. Thus, a bank, by obtaining $1000 through rediscounting at 5 per cent, is enabled to lend, say, $1500 to business men at 6 per cent. And even if the rediscount rate is raised, the bank may continue to lend extensively and profitably to its customers without charging them more than the former rate of interest, namely, 6 per cent.

Of course, when a member bank obtains an additional reserve of $1000 in this way, it has the *legal* right to increase the demand de-

posits of its customers by lending (by any amount up to $10,000, on the average) on the basis of the small legal reserve normally required against demand deposits. This right, however, cannot be exercised by one bank alone. If a single bank expanded its deposits in this way, the enlarged deposits would cause a very large number of checks to be drawn against the bank by its depositors. The clearing-house claims against this bank would then be much larger than the bank's claims against the other banks in the clearing house. These daily net adverse balances would eventually drain away much of the bank's working cash, and force it to reduce its deposits. However, when all or most member banks are rediscounting and expanding credit, a given bank may reach something approaching the maximum legal average expansibility of ten times the amount of reserve added by rediscounting; for under these circumstances the checks drawn by its customers against demand deposits are largely offset by the checks it receives which are drawn on other member banks. If this is the situation, even a 5 per cent rise in the rediscount rate would mean a rise of only one-half of one per cent, or a little more, in the interest rate charged to business men. In practice, the member banks might not raise their interest rates at all.

Even if this policy of the Federal Reserve control succeeded in raising the rates which member banks charged business men, the rise might not check borrowing greatly. When a businessman expects to make a profit of 10 or 20 per cent by using borrowed funds, he is unlikely to be restrained by the necessity of having to pay, say, an additional one per cent for these funds. Finally, it is entirely possible that our domestic policy of control might be upset by concerns in foreign countries, should they decide to take advantage of the high interest rate by making us extensive loans. And even domestic corporations with idle funds might throw them into the market if the interest rate obtainable were very high.

Ineffective as changes in rediscount rates have been in preventing the overexpansion of credit, they have been even less successful in checking its contraction. In periods of poor business, there is ordinarily little or no rediscounting, so that a lowering of rediscount rates means little. At such times, member banks are likely to lower their interest rates to business men in any case. The truth is that, in a period of declining business, enterprisers do not want to borrow from member banks for normal commercial credit purposes, and the banks are not anxious to lend. When a business man

thinks he cannot make profits by using borrowed funds, he is unlikely to borrow even if the interest rate is only one per cent.

Open-Market Operations. The other major power originally given to the Federal Reserve System for controlling commercial credit is open-market operations. This device functions through the rediscount rate, though indirectly. When there is danger of commercial credit being overexpanded, the Federal Reserve banks may decide to sell, say, a billion dollars' worth of government bonds in the open market. These securities will be bought by business men, corporations, banks, and other financial institutions. Let us suppose, for the sake of simplicity, that they are all bought by business men who pay the Federal Reserve banks with checks against demand deposits in member banks. These checks will be charged by the Federal Reserve banks against the reserve accounts of the member banks. This will lower the legal reserves of the member banks by a billion dollars, and the demand deposits which they may legally carry for business men by roughly ten times this amount. Hence, the member banks will have to curtail credit or replenish their reserves by rediscounting at the Reserve banks. If they do the latter, they will find that they must pay higher rediscount rates than before. In this way, the open-market operations are intended to make the changes in rediscount rates effective. However, since open-market operations must work through changes in rediscount rates, they cannot be more effective in checking credit expansion than a change in the rediscount rate itself would be.

When business is slack, the purchase of securities in the open market by the Federal Reserve banks is expected to increase the reserves and idle funds of the member banks, and thus stimulate lending by these banks. Here, again, the open-market operation is not likely to be effective. If idle funds are thrust upon member banks through open-market operations, the banks will probably use them to reduce their debts and increase their liquidity, or to purchase government bonds, rather than to make new loans to business men.

Other Factors in Credit Control. Changes in rediscount rates and open-market operations were, until recent years, the only means by which the Federal Reserve System could control the expansion and contraction of commercial credit, unless one includes the doubtful measures of persuasion and exhortation. However, even if the powers of control were adequate, there would remain the difficult

matter of deciding just when to use them. To determine precisely when the further issuance of money and credit would be unsafe, the officials in charge would have to possess almost superhuman knowledge and ability. And yet the controls must be applied at exactly the right time if they are to be effective and not restrain desirable business activity. Even if it were possible to determine exactly when control should be exercised, it would take great courage to adopt the necessary measures at that time, in the face of the economic, political, and international pressure which might be exerted by those who would be adversely affected.

Additions to Control Powers. In the Banking Acts of 1933 and 1935, changes were made in the organization of the Federal Reserve System and in its credit control powers. The Board of Governors of the Federal Reserve System (formerly called the Federal Reserve Board) now consists of seven members, who are appointed by the President of the United States with the approval of the Senate. In the Act of 1935, it was specified that Board members should serve terms of fourteen years each at a salary of $15,000 per annum, that their terms should expire in rotation, and that members could not be reappointed. These changes were intended to increase the independence and detachment of the Board, and to enable it to exercise its powers, when necessary, without fear of outside influence.

Increased powers were also granted the Board of Governors of the System. This Board now constitutes a majority of the membership of the Federal Open-Market Committee, and can control its decisions. Formerly this Committee of twelve was elected to represent the twelve Federal Reserve banks. Today, only five of the twelve represent these banks. Moreover, the decisions of the Committee to engage or not engage in open-market operations are now binding on the Reserve banks. These banks must submit their proposed rediscount rates to the Board of Governors at least once in every two-week period, and the rates must be approved by the Board before they become effective. This gives the Board of Governors control, for all practical purposes, over the rediscount rates charged by the Federal Reserve banks.

In addition to being given direct authority over rediscount rates and open-market operations, the Board has received other new powers for controlling commercial credit. First, it may now increase the reserve requirements that member banks must hold against demand and time deposits, by any amount up to double the long-

established requirements of 13, 10, and 7 per cent (3 per cent for time deposits) for the three classes of member banks. (Several changes actually made by the Board brought the reserve requirements, as of October, 1941, to 26, 20, and 14 per cent.) Doubling the reserve requirements has the effect of reducing by one-half the ability of member banks to extend demand deposits to business men on the basis of a given amount of reserves.

The Board of Governors may fix, for each Federal Reserve district, the percentage of a member bank's capital and surplus which may be extended to borrowers in the form of loans secured by stock and bond collateral. This percentage may be changed upon ten days' notice. After investigation and hearing, the Board may deny the credit facilities of the System to any member bank which appears to be lending too extensively for speculation in securities, real estate, or commodities. This power permits the Board to refuse rediscounting facilities for speculative purposes, while allowing credit to be expanded for normal business operations. Through its control over "margin" requirements, the Board also determines the percentage of the market values of securities that member banks may lend. Finally, the Board may suspend or remove any officer or director of a Federal Reserve bank, or of member banks, for continued violations of law, or unsafe and unsound banking practices.

These changes have greatly strengthened the control of the Federal Reserve System over the expansion of commercial credit. If the Board of Governors should decide to raise rediscount rates and to engage in open-market operations, and at the same time should raise to the limit the legal reserves for demand deposits of member banks, adjust margin requirements and the use of bank credit for speculative purposes, and cut off rediscounting facilities for erring member banks, it should be able to halt a movement toward the overexpansion of credit *in any ordinary situation.* It remains true, however, that credit control must be exercised wisely and courageously if desirable ends are to be reached.

Up to the present time the Board's new powers for controlling the expansion of bank credit have not received a fair trial. These powers were granted only a few years before the United States became involved in World War II and an emergency situation arose in which it became impossible to control the expansion of bank deposits and money in circulation. Participation in the war brought about an increase in federal expenditures from $12,774,000,000 in

1941 to $93,744,000,000 in 1944 and $100,405,000,000 in 1945.[1] This increase was financed in part by sharp rises in taxation and by the sale of government bonds to individuals and business firms. These methods of government finance are considered non-inflationary, since they reduce purchasing power in the hands of individuals and firms and increase it in the hands of the government. However, another large part of the increase in governmental expenditures was financed through the sale of government bonds to the banks, and this method of finance is definitely inflationary because, in this process, individuals and firms do not give up funds as the government acquires them.

The point is that when banks purchase government bonds, they pay for them by setting up demand deposits for the federal government. When the government spends these deposits, the funds find their way directly or indirectly into the hands of individuals and firms and are redeposited in the banks, where they become private rather than governmental deposits and can be used by their owners for any productive or consumptive purpose. In such a situation there is little the Board of Governors of the Federal Reserve System can do to limit the growth of bank deposits. Thus, the total deposits of all *member* banks increased from $61,717,000,000 on December 31, 1941, to $118,378,000,000 on June 30, 1945.[2] For *all* banks in the United States, demand deposits increased from $44,316,000,000 to $96,730,000,000, and time deposits from $26,476,000,000 to $41,710,000,000, over the same period, while money in circulation in the United States increased from $11,160,000,000 to $27,108,000,000.[3] Under the circumstances, the government's desire to prevent a wild inflation of prices had to find expression in direct price control, as we shall see in Chapter 11.

The Problem of Safety

Insecurity Under the National Banking System. Our commercial banks failed to provide safety for depositors prior to the introduction of the Federal Reserve System. Though national banks had to keep fairly large reserves behind demand and time deposits, the system of reserves was unsatisfactory in at least two respects. In the first place, the national banks were required to hold only a part of

[1] *Federal Reserve Bulletin*, October, 1945, p. 1047.
[2] *Ibid.*, p. 1032.
[3] *Ibid.*, pp. 1029, 1032.

their legal reserves in cash in their own vaults. The remainder might be deposited at interest with other banks; and these funds could seldom be regained in time of emergency, for the other banks often treated the deposited reserves just like any other deposits, lending or investing them while retaining only the minimum legal reserve against them.

However, even if the national banks' total reserves had been readily obtainable in time of emergency, it would still have been impossible to pay off the depositors with the reserves of 25, 25, and 15 per cent which the three classes of banks were required to hold against demand deposits. The second weakness of the old system, then, was the inability of the national banks to obtain additional funds in case of need. There was no central agency from which the national banks could borrow, in order to meet the demands of their depositors when their own reserves ran low.

Safety Under the Federal Reserve System. One of the purposes of the Federal Reserve Act, as originally passed, was to alter these conditions so as to provide safety for the depositors of member banks. Though the actual percentages of reserves required against deposits were reduced rather than increased, every member bank was compelled to keep its reserves in the Federal Reserve bank of its district, without interest. Then, in case of emergency, the Reserve bank could place at the disposal of a distressed bank not only the member bank's own reserve, in the form of cash, but additional funds from the great pool of reserves which it held for the other member banks of the district. For the Federal Reserve Act provided that a member bank should be permitted to obtain additional funds, when necessary, by rediscounting eligible commercial paper at the Federal Reserve bank. It was thought that this provision would make it unnecessary for a member bank to close its doors because of inability to obtain funds. To make assurance doubly sure, it was arranged that funds could be shifted from one district to another, in case there were runs on many member banks in a single district at a given time.

Bank Failures in Recent Years. Many people, firmly convinced that banks could not fail under the Federal Reserve System, were greatly shocked and highly indignant at the large number of bank failures that took place even in good business years, and the almost total collapse of the banking system and unprecedented toll of failures that marked the depression years of 1929–33. In the pros-

perous period from 1921 to 1929, inclusive, 995 member banks failed, while 4719 non-member banks met a similar fate. During the four depression years, 1930–33, when member and non-member banks were given a severe test, 2110 member banks and 6796 non-member banks failed.[4] Let us examine these depression figures more closely. In 1929 there were roughly twice as many non-member as member banks. If member and non-member banks had been equally safe (or equally unsafe), we should have expected the ratio of failures between non-member and member banks to be two to one. Actually the ratio was greater than three to one. This comparison indicates that member banks provided a substantially higher degree of safety for depositors than non-member banks in these depression years.

In 1933, a bank holiday was declared, and all banks in the country were closed. After a few days, the banks which seemed to be sound were licensed to reopen, while the others were required to put themselves in satisfactory condition or eventually be liquidated. Since the beginning of 1934, there have been relatively few bank failures. From 1934 to 1945, inclusive, only 28 member banks and 307 non-member banks were closed on account of financial difficulties.[5]

The failure of non-member banks should not, of course, be charged against the Federal Reserve System. Non-member banks make loans on types of securities, for lengths of time, and for amounts that would not be permitted under the Reserve System, and they persist in following banking practices which would not be tolerated in a member bank. Their reserves are not kept in accordance with the provisions of the Federal Reserve Act, but need comply only with those of state banking laws. In many cases their capitalization is smaller than the minimum required of a member bank, and the supervision to which they are subjected is often in no way comparable to that prescribed for member banks. The Federal Reserve System has no control over non-member banks, and has no authority to extend aid to them when they are in distress.

The Causes of Member Bank Failures. In spite of the relatively favorable safety record of member banks in the depression years following 1929, many people feel that altogether too many member banks failed during this period. For 2110 bank failures form a heavy casualty list for a system which aims to provide safety for depositors;

[4] *Statistical Abstract of the United States, 1939,* p. 263.
[5] *Federal Reserve Bulletin,* October, 1945, p. 1031.

and the failure of these member banks tied up deposits running into billions of dollars. We may well ask how it happened that so many member banks failed. The answer is that the causes were many and various, running all the way from the use of funds to construct a modern replica of a Greek temple as the bank's place of business, to the "borrowing" of laige sums by bank officials (sometimes without even the formality of giving a promissory note) and the loss of these funds in playing the stock market. However, the causes of many member bank failures were to be found in changes which took place in the nature of the loans and investments handled by these banks between 1921 and 1929. The figures in Table 7 will help to make these changes clear.

TABLE 7. LOANS AND INVESTMENTS OF ALL MEMBER BANKS, 1921–1929 [6]

(All figures in millions)

Year (June 30)	Investments	Loans on Securities	Loans on Real Estate	All Other Loans	Total Loans and Investments
1921	$ 6,002	$ 4,400	$ 875	$12,844	$24,121
1922	7,017	4,500	1,100	11,565	24,182
1923	7,757	4,950	1,350	12,450	26,507
1924	7,963	5,350	1,575	12,279	27,167
1925	8,863	6,718	1,875	12,062	29,518
1926	9,123	7,321	2,161	12,579	31,184
1927	9,818	8,156	2,449	12,333	32,756
1928	10,758	9,068	2,624	12,611	35,061
1929	10,052	10,095	2,750	12,814	35,711
Percentage increase, 1921–1929	67	129	214	0	48

As may be seen from this table, one type of loan seems to have been slighted during this period of rapidly expanding loans and investments. "All other loans," which include all ordinary commercial loans to business men based upon short-term, self-liquidating paper arising out of the exchange of commodities, remained virtually constant during the period. It may be that the speeding-up of delivery services made it possible for some business men to reduce

[6] Source: *Hearings, S. Res. 71, 71st Congress, 3rd Session,* p. 138, as reported by Lawrence W. Towle in his article, "Time Deposits and Price Stability," in *American Economic Review* for December, 1935, pp. 653–660.

their inventory requirements and adopt the policy of so-called hand-to-mouth buying; and perhaps other firms were reluctant to become heavily indebted to commercial banks while the bitter experiences of the 1921–22 depression were still fresh in their minds. Then, too, as the period wore on, it is possible that their own large profits provided many business men with an adequate supply of funds and that "favorable" stock market conditions induced some corporations to obtain, by the sale of additional shares of stock, funds which would ordinarily have been borrowed from the banks. Whatever the specific causes may have been, it is an undeniable fact that, despite a 48 per cent increase in total loans and investments, the member banks were performing their principal function of providing short-term *business* credit no more briskly at the end of the period than at the beginning.

But during this period large additions were made to the gold stocks of the country, bank reserves were plentiful, and the Federal Reserve System, for various reasons, quite consistently followed an "easy money" policy. Since banking is not a profitable business unless bank funds are kept at work, the member banks, in the absence of appeals for ordinary commercial loans, decided to lend in other fields. The identity of these fields may be readily established by reference to Table 7. From 1921 to 1929, member banks increased their loans on real estate by 214 per cent, their loans on stocks and bonds by 129 per cent, and their direct security purchases and other investments by 67 per cent. As a result of these changes, many member banks found themselves by 1929 in a position which raised doubts of their soundness as commercial banks.

The Question of Frozen Assets. We are not suggesting that loans should not be made on real estate and securities, or that banks should not invest in securities. Such loans are necessary and desirable, but we question that commercial banks are the best institutions to handle these kinds of business. When, during a boom period in business, commercial banks get the greater part of their assets tied up in real estate and securities, despite the fact that their depositors have the right to demand their deposits in cash either immediately or on a few days' notice, they are likely to find themselves in trouble if prosperity gives way to depression. For example, the depression years of 1929 to 1933 were marked by falling prices of securities and real estate, and many member banks were unable to recover the funds which they had lent or invested.

Of course, the member banks' "call loans" to brokers, secured by stocks and bonds, were safe for the most part; and loans to other customers, advanced to buy securities, probably led to few losses when these loans were made on adequate "margin." For if the customers failed to pay their indebtedness, the banks could usually sell the securities for enough to cover the loans. However, some losses were doubtless taken on loans of this type, when bankers had imprudently lent too high a percentage of the inflated values of securities—for the slump in security prices was sudden and drastic. In many cases, the loans on real estate, which had seemed very conservative on the basis of the inflated valuation of the properties, were found to be uncollectible, for the depression prices of many parcels of real estate were less than the amounts that had been lent on them. Similarly, the banks' directly owned securities and other investments declined rapidly in value, and the efforts of distressed banks to liquidate these investments speeded the decline. Consequently, when depositors began to demand their deposits, member banks found themselves in serious difficulties.

But were not the Reserve banks expected, in such troublous times, to come to the rescue of their members? It was, indeed, a time when aid was needed, but the member banks were often not in a position to claim and receive aid. For membership in the Federal Reserve System was never an absolute guaranty of safety for a bank. The statement that the System would not allow member banks to fail meant merely that the Reserve banks would place funds, in practically unlimited amounts, at the disposal of member banks which had not impaired their borrowing power through dishonest or imprudent banking practices, and which had on hand a supply of collateral eligible for rediscounting. The Reserve banks could advance funds to members (1) by rediscounting eligible commercial paper, and (2) by discounting promissory notes of the member banks themselves, when secured by government bonds.

However, eligible commercial paper and government bonds are likely to be scarce in the case of banks that have lent extensively on other types of collateral. The Reserve banks could not legally rediscount paper based on stocks and bonds, or real estate mortgages; nor could they lend on the member banks' direct investments, unless these took the form of government bonds. So far as we know, no member bank failed during the depression because the Reserve banks were short of funds, but many failed because their assets were

such that the Reserve banks could not legally aid them. And it developed that some member banks were signing their own death warrants when they overexpanded certain types of loans and investments from 1921 to 1929, though at the time they seemed merely to be sharing in what many people regarded as a new and permanent era of prosperity.

The Attitude of the Public. It would be both unfair and misleading to say that every member bank that failed richly deserved to do so. The banks that took improperly secured mortgages, and unseasoned, high-yield, narrow-market bonds, or that made loans on securities which were inadequately margined, inadequately diversified, or which otherwise failed to measure up to sound banking standards, were responsible for their own fate.[7] Moreover, the conditions were even less satisfactory in non-member banks. However, some banks failed, or were at least seriously embarrassed, because of hysteria on the part of the banking public, and not because they were unsafe. Some banks that had been reasonably prudent were forced to close their doors because unreasoning fear on the part of their depositors led them to demand immediate cash for their deposits. And in some cases these demands could not be met because the banks had, in all good faith, accepted commercial paper which proved later to be worthless, since the firms that issued it had been forced into bankruptcy by the depression. It would seem, then, that a banking system is not much stronger than its weakest bank. Had not the failure of certain large banks disclosed the existence of unsound conditions in the banking world, the depositors of other banks might not have questioned the safety of their deposits, and thus runs on essentially sound banks might have been avoided.

Recent Legislative Changes Affecting Safety: Separation of Commercial and Investment Banking. In view of the general criticism of our commercial banking system in recent years, it was inevitable that legislative steps should be taken to remedy the situation. Let us examine this legislation, considering first the measures taken to separate investment and commercial banking.

The Banking Act of 1933 provided that member banks must give up their security affiliates within one year. These affiliates were com-

[7] So said Winthrop W. Aldrich, noted New York banker, in suggesting ways of improving the banking system, before the Sub-Committee of the United States Senate Committee on Banking and Currency at Washington, November 29, 1933.

panies organized and controlled by commercial banks for the purpose of engaging in investment banking operations. These operations, which had proved very profitable prior to 1929, could not legally be performed directly by member banks. Though the relations of commercial banks with their security affiliates were often entirely wholesome and aboveboard, there were cases in which the reverse was true. The affiliates sometimes unloaded doubtful securities on the commercial banks—securities which the banks would not have purchased from anyone else—and the banks sometimes made loans to their affiliates in amounts and on securities which would not have been considered by the directors of independent banks. Hence, the separation of the two types of banking was probably necessary, if we are to have a sound commercial banking system. It was also provided that investment banks shall not be allowed to hold demand deposits, and that no officer or director of a member bank shall be an officer or director of an investment banking firm.

We must also emphasize at this point the fact that the Board of Governors of the System has authority to regulate the percentage of member banks' capital and surplus which may be tied up in security loans, and may deny rediscounting facilities to member banks which misbehave in this respect. Formerly, the Reserve banks were required to rediscount for member banks whenever eligible paper was presented, and the member banks could use the funds for speculative or other purposes. Member banks are now prohibited from making call loans "for others"—the others being individuals, corporations, or foreign groups who wish their funds to be used temporarily for speculative purposes with the privilege of withdrawing them at any time. Member banks may not underwrite securities, may deal in securities only as agents of their customers, and may not have more than 10 per cent of their own capital and surplus invested in the securities of any one obligor.

Loans to Officers. One of the evils of our banking system in the past was borrowing by executive officers from their own banks on collateral of doubtful value. The Act of 1933 provided that officers of member banks may not borrow from their own banks and must report any personal loans from other banks. However, according to the Act of 1935, banks may lend to officers of member banks in amounts up to $2500, provided the loans have received the prior approval of a majority of the directors of the lending banks.

These regulations are probably desirable and, if they have the

effect of keeping member banks within their legitimate field of commercial banking, may add to the safety of their depositors. However, it must be remembered that the effect of such legislation, with respect to both elasticity and safety, may be offset in part by the non-member banks, which are not controlled by federal legislation. Moreover, there may be other ways to render the regulations ineffective. For example, prior to 1933, a business man who wished to play the stock market might leave his own funds in his business as capital and speculate with borrowed funds. Now, however, he might speculate with his own funds and borrow from a commercial bank to finance the short-time needs of his business. In such cases, the bank's safety may be increased, but speculation is not controlled.

Changes in Member Bank Borrowing. The Banking Acts of 1933 and 1935 also changed the terms on which member banks may borrow from Reserve banks, and provided a system of federal deposit insurance for bank depositors. During the depression, depositors were sometimes unable to get cash on demand, because of the inability of the banks to turn their assets into cash promptly. The obvious remedy was to make all kinds of commercial paper eligible for rediscount at the Federal Reserve banks. The new law did not do this, but it did something almost as unwise, for it provided that member banks may borrow from Reserve banks on their own promissory notes, secured in any way satisfactory to the Reserve banks. These loans may be made for four months or less at a rate of interest only one-half of one per cent higher than the highest rediscount rate in effect at the Reserve banks. This means that, while only eligible paper may be rediscounted, member banks may, in effect, turn their ineligible paper and other assets into cash at Reserve banks and may thus be protected from the logical results of their unsound policies in lending on real estate and securities, and investing directly in securities. This policy may give greater safety to depositors, but it is extremely doubtful that it will raise the standards of commercial banking.

Loans on Real Estate. The Act of 1935 also lowered the restrictions on real estate loans by member banks. These loans could formerly be made up to a total equal to 25 per cent of a bank's unimpaired capital and surplus, or 50 per cent of its savings deposits, whichever was greater; whereas the new limit is 100 per cent of capital and surplus, or 60 per cent of time and savings deposits, whichever is greater. The individual loans could formerly be made

only up to 50 per cent of the value of the real estate, and for five years or less. Now they may be made for ten years and up to 60 per cent of the appraisal value, provided 40 per cent of the principal of the loan is paid in installments over the ten-year period. Moreover, such loans are renewable.

These new provisions relating to borrowing by member banks from Reserve banks and to real estate loans appear to us to be objectionable, though they are thoroughly approved by some writers on banking. These writers hold that investments and loans on real estate and securities have become an increasingly important part of the commercial banks' business in recent years and that, under the circumstances, it is silly to deny the banks access to the reserves of the System merely because they cannot supply the prescribed eligible commercial paper. If depositors are to be safe, the banks must be able to convert other assets into cash at the Reserve banks in an emergency. This is comparable to saying that commercial bankers must be allowed to wander into fields where they do not belong, but that the Reserve System must protect them against getting into trouble during their wanderings and thus causing loss to others. If the premise is granted, the conclusion seems to follow; but we suggest that it would be better to keep commercial banks strictly within the field of commercial banking, and thus prevent the mistakes which are largely responsible for the losses suffered by depositors. If commercial bankers will only run their businesses as they should, they may obtain adequate assistance from the Federal Reserve System in time of need, under the old provisions for rediscounting.

The Plan for Deposit Insurance. But if banks fail in spite of all that is done for them, the Act of 1935 has yet another safeguard for the depositors—for the Act provides for federal insurance of bank deposits through the Federal Deposit Insurance Corporation (hereafter referred to as the F.D.I.C.), whose original capital was furnished by the government and the Federal Reserve banks. All banks which were insured under a temporary plan provided by the Act of 1933 may continue to be insured. Member banks are required, and non-member banks permitted, to take out deposit insurance. New national banks and state member banks must qualify for insurance before receiving their charters, and non-member banks not already insured may be granted insurance after passing an examination. The F.D.I.C. may deny insurance to any bank it considers unsound

or unnecessary, and banks may withdraw from the insurance system at will, or may be excluded for violation of rules. By the middle of 1945, the F.D.I.C. was insuring the deposits of 13,277 commercial banks, or about 95 per cent of the total.[8] The insured banks had more than 75,000,000 deposit accounts and total deposits (including governmental and interbank deposits) of over $134,000,000,000.

The F.D.I.C. provides insurance for each depositor of an insured bank up to $5000. Persons having larger funds may secure full coverage by depositing with several banks. It was estimated in 1938 that 98.4 per cent of all depositors' accounts *by number* were fully covered by insurance, though only 43.5 per cent of all deposits *by value* were similarly protected.[9] Since 1938 there has been a much greater increase in total deposits than in the number of depositors' accounts, and many more accounts than formerly must now be in excess of $5000. As a result, both of the percentages noted above have doubtless declined considerably in the past few years. If an insured bank is in danger of failing, the F.D.I.C. may act as receiver and take direct responsibility for the bank's deposits, or it may make loans to or purchase assets from insured banks in order to facilitate a merger or consolidation of the threatened bank with another insured bank. In practice, the latter method of assistance is more commonly used.

Evaluation of Deposit Insurance. Deposit insurance may be criticized from several angles. From a technical point of view, it may be questioned whether it is wise to provide insurance at a flat premium for all banks without regard to the risk involved. In other types of insurance, the principle employed is to vary premiums as between classes or individuals, according to the degrees of risk represented. Moreover, a flat premium rate based on total deposits seems to discriminate in favor of small banks; for a small bank may secure practically complete coverage of its deposits by paying the flat premium on total deposits, while a large bank with many deposits over $5000 may have only a fraction of its total deposits covered by insurance although it pays a premium based on total deposits. This discrimination is not necessarily undesirable.

Furthermore, there is some doubt that bank deposits are genuinely insurable. Our experience in the post-1929 depression showed that a considerable number of banks may get into trouble at one time, and

[8] *Federal Reserve Bulletin,* October, 1945, p. 1032.
[9] *Annual Report of the Federal Deposit Insurance Corporation,* 1938, p. 80.

if this should happen in the future the F.D.I.C. might have serious financial difficulties. It is argued that a risk, to be really insurable, must be one which will not result unfavorably for many or most of the insured at any given time. Fire insurance companies would hesitate to grant insurance if there were any likelihood that all or most of the insured properties would be destroyed by fire at any one time. A popular answer to this objection is that depositors will no longer take part in runs on banks, since they know that the government stands behind the deposits, but this answer is not wholly convincing. In spite of the protection provided by insurance, the deposits in a bank that fails will not be available for depositors the next day, or even the next week. Some little time will necessarily elapse before all depositors will be paid. Since this is true, the desire to have one's money now rather than later may lead to bank runs as in the past, and cause the F.D.I.C. real embarrassment. If necessary, the government would doubtless provide the corporation with additional funds to prevent its failure; but if the need for such governmental aid should develop, the "insurance" of deposits, as such, would appear to be unsound. It is entirely possible that bank deposits could be handled through the application of the accepted principles of insurance, by carefully selecting the banks whose deposits are to be insured and charging premiums adapted to the risks, but many people have had doubts about our present system of insurance. Again, deposit insurance—especially insurance on a flat-rate basis—has been objected to on the ground that it may encourage recklessness on the part of some bankers, since they know that, because of the insurance, their actions will not cause loss to their depositors.

Quite apart from these criticisms, it is appropriate to ask whether deposit insurance of some kind is or is not a necessary and desirable adjunct of a sound system of commercial banking. Our answer is in the negative, and the basis of this answer is a familiar one. If we were to assume that commercial bankers through unsound banking practices would continue, in the future as in the past, to get into difficulties which would result in serious loss to their depositors, then we should be inclined to endorse federal deposit insurance. But we object to this assumption, since we contend that the depositors in a soundly conducted system of commercial banking would be adequately protected, in general, without recourse to government assistance in this form. Hence, we cannot regard deposit insurance

as the best possible method of safeguarding the interests of depositors.

On the other hand, many arguments have been advanced in favor of deposit insurance. It is said to be costless to the banks themselves. The argument is that the banks lose heavily whenever business men and other depositors lose their confidence in them, as they do after a period of bank failures, so that to buy insurance is cheaper than not to have it. It is believed that deposit insurance will stimulate the growth of savings deposits and prevent hoarding, and will aid in protecting sound banks against the runs which are common when weak banks fail. Finally, attention is frequently called to the helplessness of the depositors in the absence of insurance; to the inadequacy of the protection which they receive through governmental supervision and examination of banks; to the public character of banking; and to its great importance in our national economic life, which makes it imperative to avoid bank panics if it is at all possible to do so.

The Results of Deposit Insurance. The fears that have been expressed about our system of deposit insurance have not been realized up to the present time, and the record of the F.D.I.C. has been favorable. In eleven years of operation, the F.D.I.C. paid out or set aside for payment some $260,000,000 "in connection with the failure or rehabilitation of 397 insolvent or hazardous banks." The F.D.I.C. estimates that only $39,000,000 out of the $260,000,000, or 15 per cent, should be considered a total loss. The total expenditures of the corporation, including these final losses, amounted to $77,000,000 in this period. The premiums paid by the insured banks brought in $470,000,000 and the corporation received $122,000,000 as investment income, so that the total income exceeded total expenses by $515,000,000 over this period, and the surplus of the F.D.I.C. was increased by this amount.[10]

It also appears that the F.D.I.C. may be a strong force making for better banking standards in our system. It has the right to examine all insured banks, or to review the examinations of these banks. It actually examines all insured banks which do not belong to the Federal Reserve System, but it leaves the examination of national banks to the Comptroller of the Currency, and that of state member banks to the Board of Governors of the Federal Reserve

[10] *Ibid.*, 1944, pp. 19, 28.

System. It "cites" insured banks for violations of laws and regulations and for unsafe and unsound practices, and can terminate their insurance if they do not improve their behavior. Non-insured banks which desire insurance as non-member banks, insured non-member banks which wish to retire or reduce their capital or to establish or relocate branches, and insured banks of any kind which seek to assume the deposits of, or merge or consolidate with, non-insured banks, must obtain permission from the F.D.I.C. The F.D.I.C. has power to regulate the rate of interest paid by insured banks on time deposits, and banks are no longer permitted to pay interest on demand deposits. Finally, the operation of deposit insurance probably deters would-be bankers from starting unsound and unnecessary banks, since such banks may be refused deposit insurance and few people will care to entrust their deposits to banks that do not carry insurance of this kind.

The Need for Further Changes

With safety for depositors already achieved, the chief problem of commercial banking in the United States is adequate control over the expansion and contraction of bank credit. Some students of banking problems question that such control is possible so long as we have a separate system of commercial banking for each state, side by side with the Federal Reserve System for member banks all over the country. With forty-eight state banking systems, each operating under its own banking laws, and with the state-chartered banks at least partly beyond the reach of federal control, effective regulation of commercial banking as a whole is most difficult of achievement.

Compulsory Membership in the Federal Reserve System. From this point of view, the first step in genuine reform is to require every commercial bank in the United States to join the Federal Reserve System. This requirement would bring all commercial banks under one general plan, with the result that our national banking laws and regulations relating to elasticity, credit control, the relations of commercial and investment banking, and safety, would function much more effectively than in the past. It is important that this measure be enforced without any lowering of requirements, especially with regard to minimum capitalization for member banks. Indeed, it would probably be well to raise the minimum capitalization to a figure substantially above the present requirement. It may

be objected that some state banks could not make the changes necessary to meet the requirements for membership in the Federal Reserve System. This is probably true; but the objection may be answered by saying that any bank which, given due notice, fails to measure up to the membership requirements is not an essential part of our commercial banking system and may well be eliminated.

Branch Banking. Many economists feel that, even if all commercial banks were members of the Federal Reserve System, we could not adequately control bank credit so long as we have some 14,000 independent banks in the country. They believe our commercial banking problems would be simplified if we adopted a nation-wide system of branch banking, such as that of Canada or England. In England, thirteen large joint-stock banks have some 9750 branches, while in Canada there are ten large banks with about 2850 branches.[11] Under such a system, the United States might have (say) ten or twenty large banks, each with hundreds of branches, and our present small independent banks would be eliminated. At present, branch banking is permitted only to a limited extent in this country. According to a recent report, we have 1230 banks that have branches, and the branches number 4071 most of them being in the same city or county as the parent bank.[12]

In support of branch banking, it is urged that a large bank with many branches could have a widespread industrial and geographical diversification of assets and liabilities which would prevent its being forced into bankruptcy by local factors affecting certain types of loans, while its size would make it possible to bear heavy losses without becoming insolvent. Many of our recent bank failures have been those of banks with very small capital which have been unable to diversify their loans properly and have become insolvent when their principal form of loans turned out badly. Under branch banking, it is claimed, such loans could safely be made by the branches, because these loans would be combined with many other types of loans and the parent institutions would be so large that whatever losses occurred could be absorbed without serious difficulty.

A second reason for expecting a reduction in bank failures is that branch banking would probably provide what are now our smaller

[11] R. G. Thomas, *Our Modern Banking and Monetary System*, New York, Prentice-Hall, Inc., 1942, pp. 342, 343.

[12] *Annual Report of the Federal Deposit Insurance Corporation*, 1944, p. 112.

banks with a superior type of bank management. The great size of the parent banks would make it possible to employ the best of management, and all branches would benefit by this high-class managerial ability. In addition, it might be possible to require bankers to be carefully and completely trained before they were placed in positions of responsibility.

The claims for branch banking advanced thus far have dealt chiefly with safety, and the problem of safety has already been largely solved in the United States. However, it would be desirable to have a system in which safety results from the *inherent soundness* of the commercial banks. It seems improbable that branch banking would bring a significant change in the *ability* of money and credit to expand and contract. However, the *control* of elasticity might be somewhat more effective than under our present system. It might be easier to induce a few large banks to cooperate in the control of credit than to get cooperation from thousands of more or less independent banks; and, furthermore, the enforcement of banking laws and regulations might be simplified under branch banking. Of course, the problem of proper examination of the banks and their branches would still be a formidable one.

On the other hand, it is possible that the higher type of management under branch banking might be offset to some extent by the heavy cost of the central organization, the red tape involved in its operation, delays in making decisions, and an extensive division of responsibility. A system of branch banking might retard the economic development of the country. Small depositors and borrowers might be neglected because of the greater profitability of large accounts and the inability of small borrowers to furnish collateral security acceptable under the rules of the parent bank. Branch banks might find it difficult to adapt themselves to changing economic conditions. Large institutions often depend extensively upon formal rules and regulations in operating their business, and branch banking might result in a relative fixity of policy which would lessen the ability of the banking system to adapt itself to the varying needs of different sections of the country.

Finally, it is sometimes contended that branch banking might lead to a concentration of power which we would find intolerable. Those in control of the few great banks might come into control of industry, and dominate fiscal and Federal Reserve policies as well. Since the branch banks would be operated for profit, such a financial

monopoly might adjust the issuance of commercial credit to the needs of the country even less successfully than our banking system has done in the past, and conceivably create a situation in which the banks would be safe only because of their ultimate reliance upon the credit of the government.

In attempting to reach a decision on the desirability of branch banking, the crux of the whole matter seems to be whether the management of banking institutions would automatically be better under branch banking than under our present system of unit banking. Unless bank management improved, merely the large size of banks would be no positive guaranty of safety. Large banks with many branches *could* diversify their loans and investments to a greater extent than ordinary independent banks, but there is hardly certainty that they *would actually and automatically do so.* Countries with branch banking have had failures of banks with hundreds of branches, though in general the banking record of such countries in the great depression after 1929 was excellent. Of course, parent banks in America might be so large that the government could not afford to let them fail; but this type of safety would represent no advance over the present situation, for we have already decided that we cannot leave our independent banks free to fail.

We can scarcely deny that the excellent results obtained in other countries with branch banking systems have been largely due to superior bank management, but we are uncertain as to whether the better management has been the result of branch banking *per se* or whether it has resulted from the development, through the years, of an established tradition of sound banking plus the operation of all banks under a unified banking system and uniform laws. In Canada, for example, all commercial banks operate under a set of laws applying to the whole Dominion. Canadian commercial banks do not lend on real estate or engage in handling trust funds. They may not hold shares of bank stock, or make loans with such stocks as security. Their investments consist almost wholly of high-grade bonds or other securities which are quickly convertible into cash. Nor do they follow the common American practice of renewing a given short-term loan over and over again, until it amounts virtually to a fixed capital investment. Finally, the managers of Canadian banks are generally steeped in the principles of sound commercial banking, and have often risen from the ranks on the basis of merit alone. Such conditions might result in sound commercial banking

in any country, whether or not it had a system of branch banking.

According to the supporters of branch banking, such superior management, practices, and policies *result from* having branch banking. If this conclusion is valid, it follows that the United States should proceed to develop a complete system of branch banking as rapidly and enthusiastically as possible.

The Limitation of Commercial Banking. A vital need of banking in this country is an effective means for restricting commercial banks to the business of commercial banking. We believe that commercial banks should be forbidden to lend on real estate, for this is hardly a proper function of commercial banking. Loans on stocks and bonds should be permitted but sparingly, and then only with large margins of safety. The security investments of commercial banks should be limited to the highest and most liquid types of securities. The banks' power to make *fixed capital* loans to business men, by repeatedly renewing short-term *commercial* loans, should also be restricted sharply. Many of these types of loans and investments, which should not be made by strictly commercial banks, are appropriate for savings banks or for the savings departments of other banks; but, unless our commercial banks can learn to run their savings departments without becoming confused as to functions, it would seem desirable for commercial and savings banks to be entirely separate institutions. This comment is applicable also to trust departments now operated by commercial banks.

Under conditions such as these, there would probably be little need for deposit insurance, or for member banks to borrow from Reserve banks on the basis of so many types of security. We should no longer be troubled by an extension of deposit credit to many times the amount of money available for the conversion of deposits into cash. If the deposits of commercial banks were almost entirely the result of bringing cash items to the banks or discounting eligible commercial paper, there would be no need to have on hand, in the form of money, 100 per cent of the deposits which might have to be paid off at any time. That is, if the banks' deposits were backed almost wholly by liquid investments and by commercial paper eligible for rediscount, the banks could always secure cash at the Federal Reserve banks in quantities sufficient to stave off any run by depositors; and we should not need to liberalize the conditions for rediscounting or provide deposit insurance. The deposits of a *sound* commercial banking system are safe without outside guaranty.

The Development of Better Bankers. Perhaps our greatest need in American commercial banking is better bankers, rather than better banking laws and regulations. Many an authority on banking, wearied by the adoption of countless banking laws which appear to bring little improvement, has suggested that our commercial banking system has been overburdened with legislation but insufficiently governed by sound credit policies and practices on the part of bankers. The American attitude toward banking problems has been that, if we could pass large numbers of good laws, we should get good banking; but actual experience gives ample grounds for suspecting that it is difficult, if not impossible, to make good bankers by legislation. We have tried, by laws and regulations, to prevent banking practices which bankers in other countries, under the influence of tradition and custom, would regard as unthinkable even in the absence of laws and regulations.

No body of banking laws can be so nearly perfect that bankers cannot, if they wish, find loopholes for employing methods which may eventually have serious consequences to their own businesses and to other members of society. If banking is to remain in private hands, there is no adequate substitute for the sound judgment of bank officers as a safeguard against the improper use of credit; and it seems clear from past experience that an improvement in banking personnel must be an integral part of any advance in commercial banking. There is need for an understanding of the relation of commercial credit to the rest of our economic structure, and an appreciation of the fact that a loan may be sound and profitable in and of itself and yet, in conjunction with thousands of similar loans by other banks, disastrous for the system as a whole. It was once the custom in a certain European country for the head of a wrecked bank to take his own life, instead of hiring a battery of lawyers to defend him or departing posthaste for foreign and sunnier climes. Without going so far as to advocate such harsh measures, we are firmly convinced that our bankers must be made to recognize their obligations—that they must be brought to regard banking as a kind of public trust instead of, or at least as well as, a business conducted for private profit.

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1. Distinguish between commercial and investment credit.
2. Under what circumstances do business men need commercial credit? How may commercial banks render a service in this connection?

3. What conditions must be fulfilled if elasticity of money and commercial credit is to be attained?
4. "Both money and commercial credit were inelastic under the National Banking System." Explain.
5. How did the Federal Reserve Act attempt to provide for elasticity of money and commercial credit? Explain.
6. How was the Federal Reserve System, under the powers originally granted it, expected to control the expansion and contraction of credit?
7. Were the powers vested in the System adequate for this purpose?
8. "Open-market operations and changes in rediscount rates are really only different phases of a single method of credit control." Explain.
9. How have the powers of the Federal Reserve System for controlling the expansion of commercial credit been strengthened in recent years?
10. Explain the importance of the Board of Governors' power to alter the reserves required behind the demand and time deposits of member banks.
11. "The new powers of the Federal Reserve System for controlling the expansion of credit have not received a fair trial up to the present time." Explain.
12. Give some idea of the number of failures of member and nonmember banks from 1921 to 1933, and from 1934 to 1945.
13. What was the leading cause of member bank failures in the depression years of 1929–1933?
14. Recent banking legislation is said to have provided for the separation of commercial and investment banking. What is the meaning of this statement?
15. How did the Banking Act of 1935 change the terms on which member banks may borrow from Federal Reserve banks? Explain.
16. Explain the federal plan to insure the deposits of commercial banks under the Banking Act of 1935.
17. What problems arise in connection with a plan of deposit insurance such as we now have in the United States? Explain.
18. Is deposit insurance a necessary and desirable feature of a sound commercial banking system? Why or why not?
19. What other changes affecting the safety of depositors were included in recent banking laws? Explain.
20. Why do banking laws and regulations for credit control affect also the safety of depositors?
21. Should all commercial banks be required to become members of the Federal Reserve System? Explain.
22. Present the arguments for and against branch banking as a solution of our banking problems in the United States.
23. "A national system of branch banking should be adopted in the United States." Discuss.
24. Should we require that commercial banks limit themselves strictly to commercial banking? Explain.

25. "Even the best of banking legislation will not necessarily give us a sound system of commercial banking." What more is needed, and why?

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8. Investment Banking

An increase in population usually means an increase in economic machinery to supply the newcomers with commodities and services. An increase in individual purchasing power, permitting the use, by those in the lower income groups, of comforts or minor luxuries which have been denied them in the past, likewise leads to an expansion in productive facilities. Finally, every new invention of a practical nature—such as the automobile, air conditioning, or television—means the construction of buildings and equipment that will promptly place the new good in the hands of all who are able and willing to buy. Hence, in all economically progressive countries there is a continuing demand for fresh supplies of fixed capital with which to increase the output of economic goods.

The Nature of Investment Banking

Funds to be expended for fixed capital may be, and sometimes are, provided by the business enterprisers who use them; and, again, they may be procured by enterprisers directly from private individuals who are looking for investments which they expect to pay them a satisfactory return from year to year. But financing of this kind—directly from saver to enterpriser—is likely to be on a rather small scale, and to relate to the individual proprietorship or partnership form of business organization. Also, in instances of direct borrowing the enterpriser is often personally acquainted with those who entrust their funds to him.

Investment Bankers. It is much more common, however, to handle loans for fixed capital through banking houses that make a specialty of dispensing credit for permanent investments. Because of the need for agencies of this kind in a rapidly growing industrial society, there have developed in the United States a number of investment banking concerns, whose job is to gather together the savings of many individuals and place them at the disposal of the

few who can use them to advantage in the conduct of business ventures.

The process of collecting savings is carried on indirectly in most cases. That is to say, investment bankers do not as a rule come into direct contact with those whose funds they invest, unless the latter happen to be persons of great wealth whose accumulations are sufficiently extensive to warrant individual attention. For the most part, the established investment banking houses secure their funds by offering for sale the stocks and bonds of concerns that are about to be launched, or of established concerns that can use to advantage additional quantities of fixed capital.

The "Selection" of Investments. The process of financing a large business undertaking is far from simple. For convenience in discussion, the process is often divided into three parts—selection, underwriting, and distribution. If a group of business men should need to secure many millions of dollars' worth of capital for a new industrial project—say, the manufacture of plastics or television receiving sets —or should they wish to expand the plant or equipment of a going concern, they would be likely to open negotiations with a great investment banking house, such as J. P. Morgan and Company, or Kuhn, Loeb and Company, and request that this financial concern undertake to float an issue of stock or bonds, or perhaps both. If the banking house has no intimate knowledge of the project in question, it would undoubtedly make a careful investigation of all pertinent facts before agreeing to finance the operation. Of prime importance is the salability of the new securities, for investment bankers are seldom interested in buying stock and bonds which they cannot readily dispose of. But of almost equal importance is the safety of the project under consideration; for an investment banking house is known by the securities it sells, and its reputation is safe only as long as its customers are pleased with their purchases. Hence the need to ascertain that the business to be financed is entirely sound, and that its securities represent a safe as well as profitable investment.

"Underwriting" and "Distribution" of Securities. If, with all necessary information at hand, the investment banking house decides to undertake the task of providing the desired funds, it guarantees (or "underwrites") the sale of the necessary stocks or bonds, or both, within a specified time. The investment banker buys these securities from the company at a figure lower than the anticipated market

price, so that he may reasonably expect to make a profit from their sale. Now comes the task of disposing of the securities. To this end, the investment house usually proceeds to form an "underwriting syndicate," a temporary association made up of a number of other investment houses that are given an opportunity to join in the sale of the securities in question.

Each of the several underwriting concerns guarantees that certain amounts of the securities will actually be sold. The original banking house now offers these securities for sale to the public at, of course, a higher price than was paid for them. If the entire issue is sold without difficulty, each of the participating concerns is rewarded on the basis of the quantity that it individually underwrote, or guaranteed. If, on the other hand, some of the securities remain unsold after a specified time, they are divided among the underwriting houses in proportion to their guaranties, and are sold by each to investors on terms as advantageous as can be secured.

Underwriting, it will be seen, involves the principle of insurance, and is one of the many devices used in the business world for "spreading the risk." An investment house would usually rather have a one-twelfth interest in each of a dozen good securities, than complete responsibility in a single stock or bond that has been issued in huge quantities.

Investment bankers are sometimes called "security merchants," the great banking houses that float issues of stocks and bonds being known as wholesalers and the smaller underwriting houses as retailers. The commercial banks also play an important part in the business of providing investment credit, since they lend extensively to investment banking houses, accepting as security for the payment of the loans the stocks or bonds that the underwriters have taken over from the Morgans, the Kuhn, Loebs, and other large issuing concerns.

Our organized security exchanges, such as the New York Stock Exchange and the New York Curb Exchange, are another agency in the distribution of securities. As soon as an issue is listed on an exchange, the exchange becomes a market place in which the security may be bought and sold. The promoters of an issue sometimes manipulate the market in such a way as to cause a gradual rise in the price. This is done by offering to buy the security at progressively higher prices day by day. Thus, a stock that is being manipulated by a "pool" of bankers who are interested in disposing of large num-

bers of shares might sell today at $30 a share, tomorrow at $30.25, the next day at $30.50, and so on. Certainly no shares will be sold at less than the price offered by the pool, since holders of shares will naturally sell, if at all, at the highest price obtainable. As the price keeps rising, the general public, noting the steady increase and scenting big future profits, is drawn into the market and this new demand for shares aids materially in distributing the issue. This is one of the questionable practices restricted by the Securities Exchange Act of 1934, which we shall examine later in the chapter.

Though not all of the securities issued through investment bankers are listed on the organized exchanges, the largest, most important issues are listed. At first, many of these stocks and bonds get largely into the hands of buyers who are speculatively inclined, and who are likely to sell out in a few weeks or months and pocket the gain to be realized through whatever price increase has taken place since the date of purchase. But once a stock or bond has become established as a dependable security paying a satisfactory return, it comes more and more extensively into the possession of investors, who buy primarily for the purpose of getting a steady income from their purchases.

Reinvested Earnings. Another important means of accumulating funds for the purchase of fixed capital is the reinvestment of part of the earnings of business concerns. It is now a very common practice for great corporations not to distribute to their stockholders in the form of cash dividends as much as has been earned in a given period, say a year. Not only does the successful business enterprise usually establish a surplus fund from which to meet deficits and pay dividends in unprofitable years, but a part of the profits of good years is often laid aside with the deliberate intention of using it for expanding the business—that is, for providing fixed capital. The growth of the Ford Motor Car Company from an original investment of only $28,000 to one measured in hundreds of millions was accomplished wholly through the device of reinvested earnings, no new capital funds having been added to the business except those withheld year by year from the tremendous earnings of this company.

While additions to new capital from reinvested earnings are not so large as the additions made through the sale of stocks and bonds, they nevertheless form a very significant part of the capital accumulations of this country. Of course, earnings that are allocated to surplus add to the value of the business, and in the case of corpora-

tions are reflected in the enhanced value of the stock outstanding, provided no additional shares are issued. But boards of directors frequently issue stock dividends in lieu of cash dividends, and this action tends to hold down the selling price of the shares. On the other hand, it puts new shares in the hands of the old stockholders, who if they wish may convert their new holdings into cash by selling them to others. But whether the new shares are held or sold, the new capital funds which they represent are in the possession of the corporation. With the use of these funds, expansion may proceed without the delay and expense that might be entailed had the corporation attempted to secure these funds through the sale of stocks and bonds.

Problems of Investment Banking

Many problems of individual and social significance have arisen in connection with investment banking. One is the necessity of providing the greatest possible degree of safety for purchasers of the securities issued by investment banks. Investors must be protected from securities that are fraudulent in character, and from security salesmen who grossly overstate the possibilities of the stocks and bonds they offer to the public.

Another important problem is to insure that investment banking shall be carried on efficiently and in a manner consistent with the public welfare. More specifically, this means that investment credit must not be so extended at certain times and so restricted at others that its issuance becomes an important cumulative factor in causing business instability. It means, also, that this credit must be distributed among the industries seeking it, so as to coordinate the creation of new productive facilities with the desires of consumers. Finally, it is important that investment banks, in performing their function, shall not be permitted to get a strangle hold on industry by threatening to withhold needed credit if such control should be denied them.

Safety for Investors. Those who have securities to sell are frequently more optimistic as to the future of their stocks and bonds than the situation warrants. Consequently, many of the securities sold to the public have turned out to be worthless. This failure of securities to live up to the representations of the sellers is by no means a new economic phenomenon. Indeed, it is as old as the corporation itself. The fleecing of the public through the sale of

worthless securities has led to the adoption, by forty-three states and the District of Columbia, of laws regulating the sale of securities and, in some cases, providing for the recovery of losses incurred by those to whom they have been sold in violation of law.

But the widespread purchase of stocks and bonds in the boom period preceding 1929, followed by the loss of an estimated 25 billion dollars by the American purchasers of valueless securities, brought the question of investment frauds to a head. The result was the passage of two federal measures, the federal Securities Act and the federal Securities Exchange Act.

The Federal Securities Act. The federal Securities Act was passed in 1933. Its purpose was "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."

Without intending to interfere in any way with the enforcement of state legislation dealing with the sale of securities, this federal law was designed to insure that the buyer of stocks and bonds should be fully informed as to the standing of the company in which he was investing. The issuer of a security was required to file with the Securities and Exchange Commission (a commission of seven members appointed by the President of the United States) a registration statement which contained all information about the security which an investor needed to know. Until this statement was filed, the security could not be sold or offered for sale through any agency of transportation or communication in interstate commerce or through the mails. Once the statement was filed, the seller had to provide every buyer with a prospectus, which in reality was a summary of the information contained in the registration statement.

The Act also provided for the civil liability of security issuers to investors suffering losses, if the registration statement or prospectus contained false information or omitted material facts. All who shared in misleading the investors, including the issuing corporation, the original investment bank marketing the security, the underwriters, and even accountants and other experts, were held liable. As originally passed, the liability provisions were very severe. Purchasers of securities could recover in court their full losses on the securities, even though the false information or omissions in the registration statement or prospectus were not the cause of the loss, or were only a partial cause. The Act permitted recovery of losses by anyone

buying a security, whether or not he ever saw or relied upon the statement containing the false information or omission. Each member of an underwriting syndicate was held liable to all purchasers of a security, including the customers of other members of the syndicate as well as its own customers, and suit could be brought for the recovery of losses at any time within ten years after the public offering of the security.

Appraisal of the Federal Securities Act. The federal Securities Act aroused a good deal of protest. There was general sympathy with the aims and purposes of the Act, but it was felt that the law was unduly severe in prescribing liability for security issuers and sellers. It was held that the Act assumed guilt on the part of all connected with unfortunate security issues unless they could prove their innocence, and that it would foster litigation, false claims, and nuisance suits. It was pointed out that not all information connected with a business could be furnished to the Commission and that a fact, originally omitted from the registration statement as unimportant, might later appear to be material and relevant. Some critics even expressed a fear that the investment banking business might be practically exterminated because of the great dangers and liabilities that would have to be borne by corporations, investment bankers, and underwriters.

As a result of those protests, the federal Securities Exchange Act of 1934 amended the federal Securities Act in several respects. The purchasers of new securities may now recover full losses, without regard to causation, unless the defendant can establish that the loss was not caused, or was only partly caused, by the false information or omissions of the registration statement or prospectus. If a person buys a security before the publication of the first twelve-months' earnings statement of the issuing corporation after the date of registration, it is assumed that he relied on the information in the registration statement and prospectus. If the security is purchased later, reliance on the information must be proved. No member of an underwriting syndicate is now liable for an amount in excess of the aggregate price of his share of a security issue, and a suit to recover a loss must be brought within three years after the public offering of the securities.

The results of the operation of the Securities Act of 1933 have been both favorable and unfavorable. There is no doubt that a law encouraging honesty in the sale of securities was necessary for the

protection of investors; but the Securities Act, even with the amendments noted above, was so drastic a measure that, besides preventing abuses, it has interfered seriously with the normal functioning of the investment banking business. The Act cleansed and purified the issuance of securities, but relatively few corporate securities have been issued under its auspices, as the data in Table 8 indicate. Since 1933, new corporate security issues have in no year exceeded 15.3 per cent of those issued in 1929, and have usually

TABLE 8. NEW CAPITAL FUNDS RAISED IN THE UNITED STATES, 1929–45 [a]

(in millions)

Year	Total New Security Issues [b]	Total New Corporate Security Issues	Year	Total New Security Issues	Total New Corporate Security Issues
1929	$10,093	$8,002	1938	$2,360	$ 873
1930	6,912	4,483	1939	2,289	383
1931	3,095	1,551	1940	1,951	736
1932	1,197	325	1941	2,854	1,062
1933	720	161	1942	1,075	624
1934	1,386	178	1943	642	374
1935	1,457	404	1944	923	627
1936	1,972	1,192	1945	1,746	1,242
1937	2,138	1,225			

[a] Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics,* p. 487; *Federal Reserve Bulletin,* February, 1946, p. 168.

[b] Excludes refunding issues and direct issues of the United States government, but includes issues of foreign and domestic corporations, foreign governments, farm loan agencies, and states, municipalities, and territories.

fallen well below even this meager level. And, if it is objected that 1929 is an unfair year for purposes of comparison, we may say that there has been no year since 1933 in which the total value of new corporate securities has amounted to as much as 50 per cent of those issued in 1923 [1]—a year before the period of large security issues in the late 1920's began.

It is true, of course, that the years from 1933 to 1940 were not very prosperous ones, but, according to modern business cycle theory, one cannot logically charge a depression with *causing* a shortage of investment, for a shortage of investment *is* a depression. Moreover,

[1] B. M. Anderson, in *Financing American Prosperity,* New York, Twentieth Century Fund, 1945, p. 38.

physical conditions in the late 1930's were favorable for heavy investment, since industrial plant and machinery had become increasingly decrepit during the long depression and housing construction had been lagging for many years. It is likely, then, that the Securities Act had a sharp restraining effect on the issuance of new securities, and the reasons are not far to seek.

Under the rulings of the Securities and Exchange Commission, the prospectuses furnished to investors have always run over 20 pages in length, and 70 pages are very common.[2] The registration statements which the Commission requires are far more elaborate and voluminous. Both documents must be checked and double-checked by expensive lawyers and accountants, and the cost of preparing them has run as high as $150,000 or $200,000 in individual cases. Moreover, it takes a brave man to accept legal responsibility for all the facts contained in a 70-page prospectus or a registration statement which may run into several volumes. It is small wonder that corporations have hesitated to issue new securities. The remedy for this situation is obvious. Registration statements should probably be abandoned altogether, and it should be made possible for prospectuses for investors to be brief, although their legal characteristics should be retained. That is to say, the prospectus should reveal the material and relevant facts, and should be a document on the basis of which men may be sued for damages or otherwise punished if they falsify or omit material facts. In this way the objectives of the Securities Act could be attained without preventing the issuance of worth-while securities.

The Securities Exchange Act. In any case, the Securities Act did not afford full protection to investors, since it covered only new security issues and many investors had lost their all by purchasing securities already existing on the exchanges. Moreover, while most bonds are publicly offered, many issues of stock were formerly distributed through the security exchanges, often by manipulative practices of the type cited earlier in the chapter. For example, when an issue of stock was to be distributed, the first step was to register it, say on the New York Stock Exchange. Then the owners of the issue would make it appear active on the exchange by hiring brokers both to buy and to sell the issue for the account of the owners. For a time they might have to buy more than they sold, so that the price of the stock would show a steady rise. But eventually the

[2] *Ibid.*, p. 39.

public, attracted by the activity and price rise of the stock, would come into the market; and then the brokers, by selling more shares than they bought, could distribute the issue at the artificially high price.

The Securities Exchange Act, passed in 1934, aims to discourage such practices. Besides amending the federal Securities Act of 1933, as previously noted, it requires all security exchanges, unless exempted by the Securities and Exchange Commission, to be licensed by the Commission after furnishing certain required information. Every security issue listed on the exchanges must also be registered with the Commission by the issuing corporation. The registration statements must contain facts in ten categories enumerated by the Act, in addition to any further financial statements which the Commission may deem necessary. The corporations may also be asked to file certified reports periodically. The result is that many corporations are now required to register with and furnish information to the Commission, although they would have been exempt from such obligations under the federal Securities Act of 1933 because they have not recently attempted to issue new securities.

Control of Manipulative Practices. The Securities Exchange Act attempts to define, or give the Commission power to define, the functions of brokers, dealers, and specialists, and forbids certain manipulative practices under penalty of $10,000 fine and two years' imprisonment, or both. Under this Act, pools which are organized to make money by forcing the prices of certain securities up or down may no longer use publicity to advance their interests. They are prohibited from circulating false and misleading information about a security, from circulating any information, true or false, about prospective rises or falls in prices because of pool activity, and from paying anyone directly or indirectly for circulating such information. The creation of fictitious market activity is also forbidden. That is, it is now unlawful for any person, directly or indirectly, alone or with others, to effect a series of transactions in a registered security creating actual or apparent trading in such security or raising or depressing its price to induce purchase or sale by others. It is illegal to use the facilities of the exchanges, or of interstate commerce, or to use the United States mails for such purposes.

Corporate directors, officers, and stockholders who own 10 per cent or more of an issue of securities must file a statement with the Commission setting forth their holdings, and must report changes

in ownership during each month. If officers and directors buy and sell the securities of their own corporations within a six-month period and make a profit, the gain belongs to the corporation and may be recovered by legal action. Moreover, these officers and directors are not allowed to make "short sales" of the stocks of their corporations, in order to profit by declines in the prices of these securities. Short-selling, as a manipulative device, is brought under the Commission's control, to be regulated as it may deem advisable. It may require exchanges and exchange members to report short sales daily, and to report the coverage of short sales. "Pegging" the price of a security, through purchases by its sellers while the security is being marketed, is tolerated only under rules and regulations to be laid down by the Commission. Finally, the Board of Governors of the Federal Reserve System is given the power to control margin requirements for borrowing on securities.

Appraisal of the Securities Exchange Act. Our appraisal of the Securities Exchange Act must be similar to that of the Securities Act. There is no doubt that the security exchanges and manipulative practices on the exchanges could stand some regulation or that the Act, as administered by the Commission, was successful in cleansing and purifying the exchanges and their activities. On the other hand, it is equally clear that the Act and its administration have reduced activity on the security exchanges to a low level and made the market for securities "thin." That is, large changes in security prices now occur on the basis of relatively small volumes of buying or selling. For example, on twelve days in 1930 and 1931, over 13,000 shares were sold for each one per cent decline in stock prices and over 23,000 shares for each decline of one dollar. On twelve days in 1936 and 1937, only 4700 shares were sold for each one per cent of decline in stock prices and only 6700 shares for each decline of one dollar. On September 7, 1937, the figures were 2100 and 3400 shares, respectively.[8]

The dearth of speculative activity and the thinness of the market are due to a number of factors, some of which, such as high taxes on income in general and on capital gains in particular, are unconnected with the securities and exchange legislation. On the other hand, there are several phases of the Act and its administration which have interfered greatly with activity on the exchanges. The regulation of the buying and selling of the securities of their own

[8] *Ibid.*, p. 40.

corporations by officers and directors has prevented these individuals from taking advantage of inside information to make a profit on the exchanges, but it has also kept them from buying to support the prices of their securities when they felt the prices were becoming unwarrantedly low and from selling these securities when they thought the prices were becoming unduly high. High and inflexible margin requirements, severe regulation of the activities of specialists and floor traders, and the Commission's practice of questioning brokers and their customers concerning individual transactions on the exchanges have also operated to restrain legitimate speculative activity. Many of these matters could be corrected by a more liberal administration of the Act by the Commission, without changes in the Act itself and without great danger to its basic and desirable objectives.

The Total Volume of Investment Credit. While important though somewhat too drastic steps have been taken in the direction of providing safety for investors, very little has been done about certain other problems in the field of investment banking. One problem which must be faced in any economic system is the relative distribution of productive resources between (1) providing for present consumptive wants and (2) providing for the future through the production of capital goods. So long as productive methods remain the same and productive resources are scarce, we can enjoy a more abundant life in the future only at the expense of present consumption. Both saving and investment are necessary to the production of capital goods, and the investment bankers, through their sales of security issues, are supposed to coordinate these processes.

Prior to 1933, the investment bankers performed this function with only moderate success, for their business operated by fits and starts. In times of business prosperity, investment credit would sometimes flow in a veritable flood and get well in advance of current savings available for investment, since commercial banks would lend funds to customers to enable them to acquire securities on the installment plan. Such periodic overextensions of investment credit were partly responsible for building up the business booms which in turn gave way to depressions. At other times, the flow of investment credit would dry up until it was a mere trickle, although saving would go on at a moderate rate at least. Since 1933, the flow of investment credit has fluctuated considerably from year to year, but the total volume issued by the investment bankers has been so low

at all times that its instability has undoubtedly been less important than formerly.

Of course, the investment bankers are not wholly to blame for periods of over- and under-investment, much less for business booms and depressions. Indeed, we have already seen that they are middlemen in the investment process, acting in response to the demands of business for investment credit and the demands of individuals and institutions for securities. The bankers could scarcely market securities in dangerously large quantities unless corporations wanted huge amounts of investment credit and people could be found to buy the securities at such times. And security purchasers could not indulge their wild desire to get rich quick by buying stocks and bonds unless the commercial banks lent the funds necessary to finance these purchases. However, the investment bankers must accept some responsibility for the instability of their business.

Those who engage in business in our modern economic system find it necessary to forecast future economic conditions, such as the probable extent of markets and the prices of certain commodities. In days of prosperity, they become unduly optimistic and overestimate future earnings. This is as true of investment bankers as of business men in general. When business is good, profits are large security prices are mounting, and the future demand for consumption goods and the facilities for producing them seem unlimited, it is easy for investment bankers to overestimate the need for investment credit. And, because of the crucial importance of the extension of investment credit, the mistakes of investment bankers are likely to have rather wide repercussions.

The Distribution of Investment Credit Among Industries. The achievement of an appropriate distribution of investment credit among industries and businesses has been another problem of investment banking in the past. Since the quantity of funds available in our economic society is not sufficient to finance all the undertakings in which business men would like to engage, it is clear that some enterprisers will get the funds that they want while others go without. And since most of our industrial financing in the past was done through the investment banking houses, it is equally obvious that our investment bankers have exercised a large degree of control over production. In a very real sense, they have held the power of life and death over a large part of the productive activities of the economic world, since they were in a position to provide the

funds that a given concern needed and thus insure its operation, or veto its appeal and thus seal its doom.

The best interests of society require that whatever capital funds there are shall be distributed in such a way as to promote the most essential industries—that is, those which will contribute most to the welfare of society as a whole or whose products are most needed and desired by the people. However, the investment bankers were motivated by the desire for profit in distributing investment credit among industries and tended to extend the credit to those firms and industries which could pay most for its use. In many cases the firms and industries which could bid most effectively for investment credit were also those which deserved to receive it from the social point of view, but we could not expect this to be universally true. Thus funds might be directed by profit-seeking bankers into the construction of palaces for multimillionaires, leaving none available for the building of "model apartments" for working people, even though the millionaires were already magnificently housed and the workers were living in slums.[4]

The Domination of Industry by Investment Bankers. Investment bankers have often required, as a condition of issuing investment credit to a corporation, that the corporation appoint on its board of directors one or more members of the banking house, ostensibly for the purpose of insuring the safety of the security issue. This requirement appears innocent enough on the surface, but Americans in general were somewhat startled, some years ago, to learn that one investment house in this country, together with its dependents and allies, was represented by directorships in corporations with net assets of some 74 billion dollars, or about one-fourth of the total of American wealth at the time. This power was centered in the hands of some 167 persons in the banking house, and they held 2450 interlocking directorships in corporations.[5] It is difficult to say to what extent investment bankers control the policies of corporations at present, but certainly it would be socially undesirable for this control to develop so far that a small group of private persons, acting

[4] While the problem of allocating investment credit among industries would continue to be important, the control of this distribution by investment bankers would no longer be a significant issue if these bankers, in the future as in the immediate past, provided only relatively small total sums of investment credit for industry.

[5] H. W. Laidler, "Have We a Money Trust?" in *The World Tomorrow*, September, 1931, pp. 282–384.

as investment bankers, could dominate the economic activities of the country.

A Proposed Solution. We have already seen that the problems of investment banking declined in importance after 1933 because of the very low level of activity which prevailed in the investment banking business. During the period of World War II, these problems became still less significant, for the government acquired and used a very large part of the savings of the country. Thus in 1944, when new corporate security issues amounted to only 627 million dollars, total savings of individuals in the United States were in the neighborhood of 40 billion dollars and the gross federal debt increased by about 65 billion dollars.

Some people argue that, in the post-war period, we should proceed to put the investment bankers out of business entirely and socialize the extension of investment credit. The government would presumably absorb the savings of individuals through the sale of government bonds, and delegate to a board, probably one similar to the Board of Governors of the Federal Reserve System, the task of distributing investment credit among the industries and businesses of the country. The board would be appointed by the President of the United States. Its members would serve long terms, which would expire in rotation. They would be paid adequate salaries and be required to sever all private business connections.

In this way, it is claimed, the problems which we have discussed would be solved. There would no longer be any question of the issuance of fraudulent or worthless securities. The board would regulate the total volume of investment credit in accordance with the needs of society, and would not be induced, by any considerations of profit or loss, to overexpand credit at certain times and limit it unduly at others. All the savings absorbed by the government would be put to some productive use. The board's aim would be to distribute credit among our economic activities so that those which needed further development would be expanded, while the others would be held in check—for the members of the board would have no reason for preferring one industry to another. Finally, the danger of domination of the country's economic activity by a small group of private bankers would be removed.

Criticism of the Plan. It seems far from certain that the governmental ownership and operation of investment banking would actually solve all of these problems, if all or most other industries and

businesses were left under private ownership and operation. We may admit that the problem of safety for investors would be solved, but it would seem that a government board, like private bankers, might be too optimistic at certain times and too pessimistic at others, so that the issuance of investment credit might be marked by wide fluctuations as in the past. It would be no easy matter for the board to determine society's true need for investment credit from year to year. The problem of distributing such credit among industries and businesses in accordance with the social need would still be a difficult one, and mistakes could be made by a government board quite as well as by private bankers.

Finally, the board would eventually influence economic activity far more strongly than the investment bankers have ever done, and there is no assurance that governmental control would provide a remedy for the ravages of private control. Under governmental ownership and operation, the issuance of investment credit might be backward rather than progressive, so that new industries could not develop as in the past, because of the government's unwillingness to assume risks. The issuance of investment credit would be involved in red tape and subject to political control, and political "pull" would be used in obtaining desired funds.

If the governmental ownership and operation of investment banking were to be accompanied by the socialization of all or almost all of the other industries and businesses of the country, we may concede that the problems of investment banking as a private business could be solved or would disappear. However, in that case we would have on our hands a planned and controlled socialist economy, and would have solved or eliminated the problems of capitalism by accepting those of socialism. Could we keep any significant degree of economic and political freedom in a planned socialized economy? Would such an economy be efficient and progressive? Would it furnish a high level of income? Would individuals have adequate incentives? Could economic planners suit production to basic human needs and desires more effectively than the capitalistic price system does? Questions of this sort will be discussed at length in Chapter 24. For the present we merely suggest that such things as a degree of instability in economic activity and some inefficiency in the distribution of resources among industries may be part of the price we have to pay for the privilege of living in a free society.

1. What are the ways in which business enterprisers may obtain funds for investment in fixed capital?
2. What is the function of the investment bank?
3. Explain what is meant by the "selection," "underwriting," and "distribution" of securities.
4. Show the way in which fixed capital is provided through the reinvestment of earnings.
5. What are the problems of investment banking?
6. Explain how the problem of providing safety for security purchasers became acute in recent years. How did the federal Securities Act of 1933 undertake to provide this safety?
7. Criticize the federal Securities Act both constructively and destructively.
8. "The federal Securities Act, besides preventing abuses in the issuance of securities, has interfered seriously with the normal functioning of the investment banking business." Explain.
9. Why was additional legislation necessary for the protection of security purchasers? How was the Securities Exchange Act of 1934 supposed to be helpful in this connection?
10. "The results produced by the Securities Exchange Act and its enforcement have been both favorable and unfavorable." Explain.
11. What problem exists in connection with the total volume of investment credit issued by investment bankers? To what extent are the investment bankers themselves responsible for the existence of this difficulty?
12. Do investment bankers distribute investment credit among industries and businesses in true accordance with society's needs? Explain.
13. "It is obvious that our investment bankers exercise a large degree of control over production." In what way?
14. Can the problems of investment banking be solved while this business remains in private hands?
15. "The socialization of the investment banking business would readily solve or eliminate all of the problems of investment banking." Discuss.

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9. *Public Expenditures and Public Borrowing*

"*Government*," *it has been said*, "*as a form of social organization*, has developed because, in the long run, it has afforded the means of supplying men with certain services more efficiently and more economically than these could have been supplied by each for himself."[1] All economic systems of the present day are marked, to a greater or smaller extent, by division of labor. Each individual performs a single function, or a limited number of functions, and trusts to others to furnish him with the wide variety of commodities and services which he does not produce for himself. In the case of some services it seems the part of wisdom to look to the government for a more satisfactory performance than could be expected from private individuals or companies. The delegation of the provision of such services to and their performance by the government may be viewed simply as a part of division of labor.

The Nature of Governmental Functions. These functions which are performed collectively rather than by individuals are of several kinds. Some services, such as furnishing protection or maintaining law and order, would be very difficult, if not impossible, for the citizen to perform for himself. Others that could be and sometimes are carried out by private companies are often turned over to the government in the hope that they will thus be performed more efficiently or cheaply. Examples are the provision of water and electricity by municipalities. Still other functions must be performed by the government, if they are to be done at all, because an individual's share in the resulting benefits is so small or so long deferred that he would not be moved by self-interest to undertake them himself. The establishment of institutions for dependents and defectives may be cited as an example. Even when an activity is left in the hands

[1] H. L. Lutz, *Public Finance*, New York, D. Appleton & Company, Inc., 1936, p. 1.

of private individuals, the government is often called upon to exercise a restrictive and regulatory influence. Thus we have a Pure Food and Drugs Act, a Sherman Anti-Trust Act, a Securities Act, and other legislation designed to protect the interests of the public. The exact nature of the individual governmental functions will become apparent as we discuss the expenditures of federal, state, and local governments.

Governmental Functions and Expenditures. The functions of these governmental units, though they differ in many particulars, are alike in one respect—they all involve the expenditure of funds. There has been a marked tendency for public expenditures to increase during the past few decades, not only in the United States but in others countries, and for both the national and other governmental units. The increasing activities and expenditures of governments involve problems of vital importance to everyone. One problem is to decide to what extent we may best satisfy our desires by the collective utilization of our resources, natural and human, rather than by leaving to private individuals the task of providing certain needed commodities and services. That is, we must consider how large a part of our real income we wish to receive collectively rather than individually. The discussion of this problem ordinarily assumes that the great bulk of economic activities will be left in private hands and that the economic system as a whole will continue to operate in capitalistic fashion.

A second and very important problem is to decide whether the government may properly use its fiscal policy to control the operation of the economic system as a whole. Should the functions of government include the assumption of responsibility for the successful operation of the economic system? Should the government, through its expenditures and other elements of fiscal policy, attempt to maintain the aggregate demand for goods in the economy so that a high and stable level of production, income, and employment will be attained? Are such governmental functions and expenditures compatible with the continued operation of a capitalistic type of economic system? Questions of this kind are very definitely at issue at the present time.

Increases in Public Expenditures

Expenditures of the Federal Government. In investigating the problems of public expenditures, let us consider first the increase in public expenditures in the United States and the nature of these

expenditures in recent years. The expenses of our federal government increased from $517,000,000 in 1903 to $725,000,000 in 1913, to $3,437,000,000 in 1928, and to $12,711,000,000 in 1941.[2] The increase from 1903 to 1941 was 2358 per cent. However, even the large expenditures of 1941 were smaller than those of some years during World War I, and very small indeed by comparison with those which were yet to come. During World War II, federal expenditures skyrocketed to a peak of $100,405,000,000 in 1945, or about eight times the 1941 expenditures.[3]

Expenditures for protection (national defense) are always a very important item in the federal budget. In 1945, as we see in Table 9, direct expenditures for war amounted to $90,029,000,000, or 89.7 per cent of the total federal expenditures. If expenditures for interest on the public debt and for veterans' pensions and benefits are included, the total cost of national defense amounted to 95.3 per cent of all federal expenditures. In the pre-war year 1941, expenditures for national defense amounted to 47.6 per cent of the total expenditures, or about 61 per cent if the expenditures for veterans' pensions and benefits and for debt redemption and interest are included. The total cost of national defense certainly includes expenditures for the benefit of veterans, and would include all payments for debt redemption and interest on the public debt of the federal government if this debt were large solely because the federal government, in certain past years, had spent for national defense at a more rapid rate than could be covered by the ordinary governmental revenues of those years. As a matter of fact, however, a part of the public debt resulted from governmental borrowing to finance heavy expenditures during the post-1929 depression.

Expenditures for such purposes as relief and work relief for the unemployed, social security, and aids to agriculture, which had amounted to 27.9 per cent of the total in 1941, were relatively unimportant in 1945. The cost of maintaining the ordinary departments of government and other general governmental activities amounted to only 11.9 per cent of the total federal expenditures in 1941 and to 3.1 per cent in 1945. Total federal expenditures amounted to about $720 per capita in 1945, as compared with $92 in 1941. (Preliminary figures for the fiscal year 1946 indicate total federal ex-

[2] *Report of the Secretary of the Treasury, 1928,* p. 418; Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics,* p. 513.

[3] *Federal Reserve Bulletin,* February, 1946, p. 173. All the figures for federal expenditures are for fiscal years running from July 1 to June 30. Thus, the 1945 fiscal year included the period from July 1, 1944, to June 30, 1945.

penditures of $65,019,000,000, including $48,542,000,000 for national defense, war, and war liquidation; $11,982,000,000 for interest on the public debt, refunds, and veterans' pensions and benefits; $833,000,000 for international financial commitments; and $3,662,000,000 for other purposes, including general governmental activities.)

TABLE 9. EXPENDITURES OF THE FEDERAL GOVERNMENT, FISCAL YEARS 1941 AND 1945[a]

Type of Expenditure	Amount Spent in 1941 (in millions)	Per Cent of Total Expenditures, 1941	Amount Spent in 1945 (in millions)	Per Cent of Total Expenditures, 1945
National defense	$ 6,048	47.6	$ 90,029	89.7
Interest on the public debt	1,111	8.7	3,617	3.6
Veterans' pensions and benefits	553	4.4	2,044	2.0
Aids to agriculture	970	7.6	602	0.6
Social security[b]	943	7.4	982	1.0
Relief and work relief	1,637	12.9	5	....
General governmental activities[c]	1,510	11.9	3,126	3.1
Debt redemption	64	0.5	....	...
Revolving funds (excess of credits, deduct)[d]	(125)	(1.0)	. .	.
Total expenditures	$12,711	100.0	$100,405	100.0

[a] Source: United States Treasury Department statements, July 2, 1941, and August 1, 1945

[b] In 1941, this item included expenditures of the Civilian Conservation Corps and National Youth Administration, as well as ordinary expenditures for social security.

[c] Includes expenditures for regular departments of government, reclamation projects, post office deficiency, refunds of taxes and duties, District of Columbia government, river and harbor work, flood control, and the Panama Canal.

[d] Returns of funds from the Farm Credit Administration, Federal Farm Mortgage Corporation, and Public Works Administration.

Expenditures of State Governments. The state governments of the United States spent a total of $207,000,000 in 1903, $359,000,000 in 1913, $1,753,000,000 in 1928, and $3,739,071,000 in 1944.[4] The increase from 1903 to 1944 was 1706 per cent. As we see in Table 10, the largest state expenditures in 1944 were for such items as education (28.0 per cent), highways (18.5 per cent), and public welfare

[4] National Industrial Conference Board, *The Economic Almanac for 1944–45*, New York, 1944, p. 101, and *The Economic Almanac for 1945–46*, p. 106. The data include only expenditures from state funds and not grants from the federal government to the states.

(14.6 per cent). Less important items of expenditure included general government, public safety, natural resources, health, hospitals, correction, and interest on state debt. State expenditures in 1944 amounted to over $27 per capita.

TABLE 10. EXPENDITURES OF STATE GOVERNMENTS IN 1944 [a]

Type of Expenditure	Amount Spent (in millions)	Per Cent of Total Expenditures
General government	$ 171.0	4 6
Public safety	130.9	3.5
Highways	691.4	18.5
Natural resources	103.6	2.8
Health	39.3	1.0
Hospitals	276.7	7.4
Public Welfare	545.5	14.6
Correction	77.9	2.1
Education	1,045.8	28.0
Interest	92.6	2.5
Miscellaneous	564.3	15.0
Total	$3,739.0	100.0

[a] Source. National Industrial Conference Board, *The Economic Almanac for 1945–46*, New York, 1945, p. 131.

Expenditures of Local Governments. Local governments in the United States spent a total of $912,000,000 in 1903, $1,783,000,000 in 1913, $6,067,000,000 in 1928, and $4,554,000,000 in 1944.[5] The increase from 1903 to 1928 was 554 per cent, whereas that from 1903 to 1944 was only 399 per cent. Data covering the detailed items of expenditure by all local governments are not available, but we can get an idea of the nature of these expenditures by examining those of cities with 25,000 population or over in 1943, as shown in Table 11. Here we see that the largest expenditures were for education and public safety, which amounted to 21.6 and 20.7 per cent of the total, respectively. Less important items of expenditure included general government, highways, sanitation, health, hospitals, public welfare, correction, recreation, interest, and contributions to trust funds and public service enterprises. Total expenditures of federal, state, and local governments in 1944 amounted to about $750 per capita, and were almost two-thirds as great as the total national income.

[5] *Ibid.*, p. 106.

TABLE 11. EXPENDITURES OF CITIES WITH POPULATION OVER 25,000 IN 1943 [a]

Type of Expenditure	Amount Spent (in millions)	Per Cent of Total Expenditures
General government	$ 161.1	7.0
Public safety	473.8	20.7
Highways	169.8	7.4
Sanitation	154.5	6.7
Health	37.8	1.7
Hospitals	110.3	4.8
Public welfare	209.8	9.2
Correction	19.3	0.8
Education	494.4	21.6
Recreation	76.2	3.3
Interest	119.0	5.2
Contributions to trust funds and public service enterprises	199.2	8.7
Miscellaneous	64.7	2.9
Total	$2,289.9	100.0

[a] Source: National Industrial Conference Board, *The Economic Almanac for 1945–46*, New York, 1945, p. 131.

CAUSES OF INCREASES IN PUBLIC EXPENDITURES

Increase in Population. Among the more obvious causes of larger public expenditures in this country is the steady increase in the number of persons for whom governmental services must be performed. This growth in population, even if it called for nothing more than a duplication of existing governmental machinery, would bring about at least a proportional expansion in expenditures, unless it were found possible to render governmental services on the basis of mass production, with a decreasing cost per individual served. Unfortunately for our hopes in this direction, the performance of functions by the various governmental organizations seems to be subject to a law of increasing rather than decreasing costs; that is, an increase in the number of individuals cared for often involves a greater than proportional increase in the cost of rendering the services in question.

Not only does the performance of a given number of functions for an increasing number of persons bring with it an increase in the costs of government, both absolutely and per capita, but in addition

it often happens that a growth in population causes an expansion of the needs which it appears necessary or wise to satisfy collectively rather than individually. A growth in the population of a city, for example, usually brings about an expansion in the number of functions to be performed by (say) the police department, and does not mean simply that the same functions will be performed as before, though for a larger number of persons. This explains why the financial statistics of cities show a fairly steady per capita increase in public expenditures, as we pass from the smallest cities to the largest.

Changes in General Prices. Changes in the general price level and the purchasing power of money constitute another cause of the growth of public expenditures. The general price level in the United States was slightly higher in 1913 than in 1903, and was much higher in 1928 than in either of these two other years. The price level in 1941 was lower than in 1928, but in 1943 and 1945 it was considerably higher than in 1928. The national, state, and local governments, in order to render the services expected of them, must be able to obtain materials and supplies, and in general to gain access to the factors of production much as does any business man. The governments, in other words, must enter into competition with private individuals and corporations for the use of the necessary agents of production. Hence, when the prices of goods and productive factors rise, governmental expenditures must increase also, even though there is no change in the number of functions performed, or in the intensity with which they are carried on. Part of the increase in public expenditures since the turn of the century has been nominal rather than real, representing, it is true, the handling of more dollars, but not the expenditure of greater purchasing power. However, after all allowances are made for changes in the purchasing power of money, there still remains a very large growth in public expenditures to account for.

Inefficiency in the Appropriation of Public Funds. A factor which ranks high in the popular mind as a cause of increasing public expenditures is carelessness and extravagance in making appropriations for various purposes, combined with a lack of business methods, if not downright corruption, in the administration of public funds. Actually these evils can scarcely be an important cause of increasing public expenditures unless they themselves tend to increase in severity with the passage of time, but they may be an

ever-present reason why public expenditures are greater than they need to be in view of the functions performed by governments.

The appropriation of funds with which to carry on the functions of the various governmental units in the United States is in the hands of elected representatives, that is, members of national and state legislatures and of city councils. Under our political system it often happens that the qualities which make it possible for a man to be elected to such an office are not those which will make him an expert in administering the duties devolving upon him. Public expenditures are determined, as a result, largely by men who lack training in economic principles and an understanding of economic problems. As a consequence, appropriations are often made in a haphazard and piecemeal fashion, some being entirely too small and more being disproportionately large, with each individual appropriation quite unrelated to any sum which might be regarded as an appropriate total.

Some improvement in this situation has taken place in recent years, since many of the governmental units, including the federal government itself, have adopted budget systems A budget does afford some check upon appropriations, and it fixes to a certain extent the responsibility for them. However, it seems evident with each passing Congress that the evils mentioned above have not been completely eradicated. Indeed, it is likely that they cannot be eliminated until some change takes place in the attitude of large numbers of citizens toward the appropriation and expenditure of public funds.

The Popular Attitude Toward "Public Money." The democratic form of government assumes that most voters will be intelligent and socially minded; that is, that they will know how best to serve their own interests and those of others, and that they will be sufficiently unselfish to take into consideration the broad social interests rather than their own personal gain. One is tempted to doubt that this assumption is well founded, especially when one observes the attitude of some persons toward the funds of the federal government. Many people seem to regard the federal treasury as a vast reservoir into which flow mysterious but inexhaustible streams of wealth. It appears to such people that the problem in connection with the treasury is not one of economy in appropriations and expenditure, but rather that of seeing to it that their particular district or locality receives its full share of the funds—or more than its share, if pos-

sible. Representatives in the national legislature are conceived of by their constituents as agents of their district, whose duty it is to insist that an appropriate portion of governmental funds shall be diverted in its particular direction. Representatives are instructed to "bring home the money or don't come back."

The only way a representative is likely to be able to get through, for his district, an item in the appropriations bill is by enlisting the support of other members by promising to vote for the favorite projects of these members, or, in other words, by engaging in what is commonly called "logrolling" or "back-scratching." Examples of this practice are to be found in the river and harbor bills, the public buildings bills, the army and navy bills, and in most of our recent tariff bills. Scrambles for federal funds were apparent in connection with the public works and relief programs of the Roosevelt administration during the great depression of the 1930's, and again in the large expenditures during World War II. It may be noted, also, that those who complain loudly about federal extravagance and waste often grab vigorously at whatever federal funds are to be had. The probability of obtaining scientific and economical appropriations and expenditures in the face of such processes and attitudes is small.

Wastes in the Administration of Public Funds. In the administration of governmental funds, as well as in the appropriation of such funds, undesirable practices may be noted. It is difficult to obtain proper administration of offices and funds, even given the best of efforts and intentions, when the holding of such offices is dependent upon the vagaries of political fortune. It is true that under our Civil Service Laws we have some slight modification of the old-fashioned "spoils system," under which appointments to government positions were generally regarded as a legitimate part of the fruits of victory at the polls; but there is still a high rate of "turnover" in offices which must be characterized by security of tenure if efficiency is to prevail. Certainly, the folly of electing by popular vote officials who are to hold positions requiring technical knowledge and training should be apparent to everyone.

Though there are many public officials in the employ of the various governmental units who serve faithfully and well for modest salaries, it must be admitted that there are others who expend public funds in a wasteful and extravagant manner. This waste may take a variety of forms. In some cases the payrolls are padded—that is, more persons are employed than are needed to carry on the func-

tions of government, and members of an administrator's family are often placed in appointive positions. Sometimes the quantities of supplies and equipment purchased are unnecessarily large, or the prices paid are unreasonably high in view of the quality obtained. Again, contracts may be awarded to those who have not submitted the most favorable bid for the work in question. We do not mean, of course, that only in governmental hands are funds wastefully expended, for much waste occurs also in private business expenditures.

The Expansion of Governmental Functions. But after due allowance has been made for growth of population, changes in the price level, and possibly other factors, the chief explanation of increasing public expenditures is to be found in the continually growing number of functions being performed by federal, state, and local governments. This expansion of functions in turn has been largely the result of such things as the great and pressing economic problems that have arisen as our economic system has increased in size and complexity, the growing conviction that social welfare can and should be advanced by collective action through government, and the more recent notion that the government can and should assume direct responsibility for the satisfactory operation of the economic system as a whole and for the maintenance of a high level of income, production, and employment.

Economic Problems and Public Expenditures. With the development of our economic system, production has become highly specialized, roundabout, and large scale. The economy has become increasingly dependent upon a smoothly functioning system of exchange, and economic interdependence has increased. As the economic system grew larger and more complex, problems developed which often caused distress to large numbers of people and seemed to call for collective action. Examples are problems of money and banking, public utilities, transportation, monopolies and trusts, labor relations, and the issuance of securities. In many cases the attempted solutions have involved governmental regulation which has not required large public expenditures though it has added greatly to the list of governmental functions. The people in the economy continued in general to hold to the capitalistic principle that governmental interference with and control over the economic activities of private citizens is in itself not a good but an evil. However, they were willing to embrace this evil in cases in which it ap-

peared to be the means of avoiding or eliminating a greater evil. Governmental regulation in connection with such individual economic problems did not keep the economy as a whole from operating on a capitalistic basis.

Welfare Activities and Public Expenditures. State and local governments now spend large sums for highways, education, and public welfare in general. Such expenditures are thought to make for the development of our people and their economic activities, and hence for the general welfare. When the automobile was first introduced, highway construction and maintenance could be provided at a cost which would now seem remarkably low. However, the use of the automobile for pleasure has increased so rapidly that a car is at present regarded by most families as a necessity, and its use for commercial purposes has grown almost as rapidly. Traffic on the main highways has become extremely heavy, and the expense of constructing and maintaining macadam and concrete surfaces which will support giant motor trucks is very high.

As an economic system increases in complexity, it becomes more and more apparent that adequate preparation for one's life work is essential to the achievement of a high measure of success, and it becomes extremely difficult for a person to rise from the ranks if he depends upon his native ability unaided by occupational training. Also, as standards of living improve, greater educational facilities are demanded and obtained. For these and other reasons, we are at present attempting by collective action to provide everyone with a certain minimum amount of training, and to assist as many as possible to pursue higher education. Since little or no effort is made to place most of our educational activities on a self-supporting basis, the cost in the form of public expenditures is large.

There have been other large increases for hospitals, clinics, health and sanitation, recreation, and institutions for delinquents, dependents, and defectives. In the dreary days when the insane were left to "mumble in the chimney corner," when the feeble-minded were allowed to roam at will and were merely regarded as a bit queer, when sickness or even plagues were thought to be marks of divine disfavor or of evil spirits rather than results of lack of sanitation, and each family was expected to pay for its own medical attention or to go without, governmental expenditures for such purposes were not large. But nowadays we regard the satisfactory handling of these matters as vital to the public welfare, and undertake to pro-

vide for it through governmental agencies. Provision of this kind is praiseworthy, but it is also expensive.

Governmental Functions and Expenditures in the Great Depression. The idea that the federal government should assume direct responsibility for the satisfactory operation of the whole economy came to the fore in the depression years following 1929. The United States had many business depressions prior to 1929, but the earlier depressions had been allowed to run their course, apparently on the principle that recovery attained in the "natural" manner would be prompt and lasting. But in the post-1929 depression there was a widespread demand that the government take action both to promote recovery from the depression and to relieve the millions of unemployed and destitute. The response of government to this demand resulted in greatly expanded functions and enormous public expenditures.

One important depression activity was caring for the unemployed, numbering over 12 million persons at the worst of the depression. Most of these people, if unassisted, would have been not only unemployed but completely destitute, lacking even those minimum resources necessary to keep body and soul together. With state and local governments apparently unable to handle the problem, the federal government lent a helping hand. Its activities in behalf of the unemployed, through the Public Works Administration, the Civil Works Administration, the Civilian Conservation Corps, the Work Projects Administration, and assistance given the states in providing direct relief, were very costly. From 1933 to 1941, inclusive, the total expenditures for unemployment relief were about $18,000,000,000, or $26,000,000,000 if public works are included as a part of unemployment relief.

American agriculture was in a critical condition following the First World War, and suffered still further losses during the depression. The agricultural problem and its treatment by the government will be examined in Chapter 20, but we may note here that the condition of agriculture during the depression was so serious as to constitute a severe drag on general recovery, in addition to being a difficult problem in itself. The federal government, through the Agricultural Adjustment Administration, the Farm Credit Administration, the Commodity Credit Corporation, and other agencies, attempted to regulate agricultural production, raise the prices of farm products, refinance farm mortgages, and lend the farmers credit

on their holdings of various crops. The expenditures for these purposes were more than a billion dollars in certain years, and totaled over $5,000,000,000 for the period from 1933 to 1941, inclusive.

Other federal activities designed to promote recovery were less costly than those already mentioned. They included financial assistance to railroads, banks, and other institutions through the Reconstruction Finance Corporation; the refinancing of the obligations of home owners other than farmers; the promotion of the rehabilitation of industry and business through self-regulation under the National Recovery Administration; insurance for bank depositors through the Federal Deposit Insurance Corporation; the Subsistence Homesteads Projects; and the Emergency Housing Program. At the same time the federal government undertook other activities which seemed to be dedicated to reform rather than or in addition to recovery from the depression. Examples included the regulation of the issuance of new securities and of the activities of security exchanges through the Securities and Exchange Commission under laws of 1933 and 1934, the regulation of the public utility industry through the Securities and Exchange Commission and the Federal Power Commission under the Public Utilities Act of 1935, and various activities for the benefit of labor carried on under the National Labor Relations Act of 1935 and other laws.[6]

The War Period. Most of the depression activities of the federal government were still going full blast when World War II began. When the United States entered the war, governmental control over the economic activities of the country increased greatly and soon dwarfed anything that this country had ever before experienced. Long before the war was over, agencies of the federal government were controlling output in many branches of production; the prices of commodities and services; wages and salaries; rents; the allocation of essential materials and equipment among industries and businesses; the allocation of labor among industries, businesses, and the armed forces; industrial relations in many industries; imports and exports; the apportionment of certain scarce consumers' goods among the individual people; and many other things. While many persons questioned whether all of these governmental controls were

[6] In practice, the distinction between recovery and reform activities was not at all clear cut. Many activities dedicated to recovery also included certain reform features, and it was doubtless hoped that some of the reform activities would also be of some assistance in promoting recovery from the depression.

essential to the successful prosecution of the war and whether certain controls were well suited to the objectives which were being pursued, the wartime functions and expenditures of the federal government were in general accepted with good grace by the people as being more or less inevitable in such an emergency period.

Proposed Governmental Functions. During the war period many people in this country apparently came to the conclusion that, while some controls over economic activity imposed by the federal government in wartime should be relaxed in the post-war period, the federal government must continue to assume responsibility for the successful operation of the economy as a whole. Governmental functions proposed in this connection included the guarantee or underwriting of full employment by the government; the provision of a system of social security, popularly known as the "cradle-to-grave" variety, to cover many more people, provide against more risks, and furnish much larger benefits than the present system; the provision of high minimum wages or even a national minimum per capita income; and support for a high wage policy in general in order to maintain purchasing power and the total demand for goods. Such functions, as we shall see later, might have serious implications for the future of our economic system.

Proper Activities of Government

Our discussion has shown us that, except for allowances that must be made for such factors as changes in general prices, and extravagance and graft, the size of public expenditures depends upon the number and cost of the services which the various governmental units are called upon to render. Hence, in connection with the study of public expenditures, it is important to inquire how many functions should be assigned to the government. Since many of the functions now performed collectively could be carried on at least moderately well by other means, the answer which one person would give to this question might differ widely from that of another. There are some few individuals even today who believe that the ideal condition of society demands a complete absence of government. Others believe that government is a necessity but that its duties should be kept to a minimum, while still others would have all industries owned and controlled by the government—that is, by the people collectively rather than individually. Everyone would then work for the government; and it might be found wise, accord-

ing to this opinion, to extend collectivism so far as to include the collective use of the products of economic processes.

A Test for Governmental Functions and Expenditures. There is clearly no necessary end or limit to the activities or functions of government. These activities might be reduced greatly from their present status, or they might be expanded until the government controlled all economic activity. Hence, we greatly need a test which can be applied in deciding whether a given function involving a considerable expenditure should be assigned to a governmental unit or left in private hands. We may get some notion of the nature of such a test by giving thought to the purpose for which governments exist. Functions are given over to governments to perform, with the idea that services will in this way be rendered more efficiently and cheaply than they could be provided by each individual for himself. Thus it may be said that a function should be delegated to the government only when it appears that, bearing in mind the necessary costs of administration in collecting and disbursing the funds, together with whatever knowledge may be available as to the efficiency of the government in question, the expenditure of a given sum collectively will result in a more adequate and economical service than could be obtained by a similar sum privately spent.

A decision as to the aggregate amount to be collected and spent by governments in rendering the various services may be reached by having recourse to the familiar economic terms "satisfaction" and "productivity." Individuals spend their incomes for consumers' goods, usually after a consideration of the different amounts of satisfaction that are likely to be derived from the various alternative uses to which the funds in question might be put, or for producers' goods after a similar decision has been reached with regard to productivity. In other words, individuals tend to spend their incomes in such ways as will likely, all things considered, result in the realization of the greatest possible amount of satisfaction, or productivity, as the case may be. Applied to public expenditures, the principle as commonly stated is that additional funds should be collected and spent by the government just so long as the amount of satisfaction to be derived in the aggregate from the new services rendered is in excess of the amount lost in the aggregate by having to give over the funds in question to the government.

This principle should be modified to allow for the fact that a direct comparison of satisfactions is not always the one to be made.

Funds may be spent and hence have to be collected in such amounts and such ways as will indirectly have the rather serious effect of restraining or depressing business. For this reason the principle should be stated as follows: A government should collect and spend such an aggregate sum that the advantage in the form of satisfaction to be gained by any further collections and expenditures will not be sufficient to offset the disadvantage of loss of satisfaction, either direct, or indirect through the ill effects on business, by reason of turning the funds in question over to the government. Furthermore, just as an individual attempts to distribute his income among the various objects of expenditure in such a way as to make the last dollar spent for each purpose afford him as much satisfaction as could be derived from a like expenditure for any other object, so too it might be desirable to have the aggregate amount of expenditure of the government split up among the several governmental activities in such manner that no money will be spent for one purpose which would result in greater satisfaction if it were added to the sum to be spent for some other purpose.

Difficulties in the Use of This Test. It must be admitted that this test for public expenditures has its disadvantages. It has often been said that satisfaction is a matter which each individual must decide for himself, and which as a consequence cannot be accurately measured by some individuals for others. And yet, in applying this test for governmental activities and expenditures, it will be necessary for us constantly to form an opinion as to whether the satisfaction to be gained from a service to be rendered by the government will or will not exceed the loss of satisfaction, direct or indirect, suffered by the various contributors supporting the government by turning over the necessary funds in the form of taxes. In addition, the application of the test will require an accuracy of estimate and a nicety of judgment which are not always possessed by those who make decisions on questions of governmental activities and expenditures. In spite of these objections, it seems that the considerations set forth in the preceding paragraph are those which should be borne in mind in reaching such decisions.

Evaluation of Governmental Functions and Expenditures

On the basis of this test, does it appear that certain activities of our several governmental units should be curtailed or dropped entirely? We may first express doubt that any net social advantage

would result from a decision not to have the governments carry on the various functions which they were performing in the regulation and guidance of economic activity prior to 1929. Nor does it appear that greater satisfaction would be created by leaving in private hands the funds now being collected and spent by the governments for various social purposes. The need for these services has come upon us gradually and inevitably with the changes that have taken place in our social structure, and it does not seem that the responsibility for performing these functions could have been avoided under any circumstances. Under present conditions it is unthinkable that such matters as education, highways, and the provision of institutions for the care of dependents, defectives, and delinquents should be neglected. On the whole, it must be said that the great bulk of these activities of governments may be expected to stand up under the scrutiny of the proposed test for public expenditures. That is to say, these activities create sufficient satisfaction for the receivers of the services, or for society as a whole, to more than compensate for the loss of satisfaction to individuals or damage to business which may result because funds are collected in order to make it possible to carry on these functions.

The Need for Expenditures for Protection. However, there is *ordinarily* more doubt whether a similar conclusion can be reached with regard to what is usually the principal activity of the national government—the provision of protection in one form or another. Expenditures for this purpose, as has been mentioned, make up a very large part of the total expenditures of our national government, and consist in the main of payment for past wars and preparation for those of the future. Without attempting to ascertain whether the wars of the past were necessary or the extent to which maladministration may have added to the costs of these conflicts, we may note that there is a conviction on the part of many persons that, *under ordinary circumstances and from the strictly economic point of view,* war is an unwise and costly method of "settling" disputes between nations. Modern wars almost inevitably bring economic losses, and not economic gains, to all the participating nations.

If the test of satisfaction is applied to this type of expenditure, there seems to be only one way in which the test may be stretched sufficiently to make it cover the activity. If the conditions of the world today are regarded as fixed, unyielding conditions to which we may react but which we cannot change, then preparation for

war, and at times the actual waging of war, may be necessary. We do not want aggressor nations to be in a position to take our land and resources from us, or to destroy our institutions. To prevent such heavy losses, it may be worth while for us to bear the burdens involved in preparing for and waging war. Thus, war may be the lesser of two great evils, even if it results in severe economic losses. On the other hand, from the point of view of the world as a whole the billions of dollars spent for wars and armaments in the past and present have been and are economic waste. There would be a greater sum total of satisfaction from the use of economic goods if the world were freed from military conflict.

Depression Activities and Expenditures. What shall we say of the depression activities and expenditures of the federal government? From the point of view of a direct comparison of satisfactions, many of them would probably pass muster. Consider, for example, relief or work relief for the unemployed, which was the largest and probably the most severely criticized of the depression expenditures of the federal government. So far as governmental assistance was received by those who really needed it, it is hard to believe that these expenditures did not give more satisfaction to the recipients of the government's aid than they took away, or will take away, from the taxpayers. However great the pangs suffered by those who have paid or must pay taxes to cover relief expenditures, they are doubtless less painful than the pangs of death by starvation or exposure.

However, when we consider the indirect effects of the depression activities and expenditures, the answer is not so clear. The heavy expenditures had to be financed by either taxation or borrowing. To the extent that taxation was used, high taxes tended to cut into employment-creating private spending for consumption or investment as well as unnecessary saving. Moreover, some individuals in the higher tax brackets may have been rendered unwilling to put capital funds into risky ventures, since any gains which they might make would have to be shared with the government while any losses they might suffer would be almost entirely their own. To the extent that borrowing (deficit spending) was used to finance the governmental expenditures, business confidence may have been affected and fears of later higher taxes aroused, with adverse effects on the amount of production and employment furnished by private industries and businesses.

Funds for relief or work relief may have been used in some cases

for political purposes rather than to promote recovery from the depression, and the receipt of governmental assistance probably weakened the morale of some persons and made them anxious to make a "career" of the W.P.A. or to "retire" on relief, rather than to shift for themselves in private employment. The laws of 1933 and 1934 may have cleansed and purified the issuance of securities and the operation of the security exchanges, but, according to some authorities, they also brought the issuance of new corporate securities almost to a standstill and greatly weakened the functioning of the security exchanges. Though the activities in behalf of labor greatly improved the bargaining power of employed workers, they may have made enterprisers less willing than they would otherwise have been to undertake production and furnish employment. Direct competition with private business by governmental enterprises or agencies, or even the threat of such competition, and the general attitude of hostility toward private industry and business on the part of the federal government, may have had similarly detrimental effects.

Other examples could be given, but those presented above may be adequate to suggest that the assumption by the government that the capitalistic system could not handle the situation may have led to governmental activities which increased the probability that capitalism would be unable to operate successfully. It is impossible to know whether our economic system as a whole was actually better off by (say) 1940 than it would have been if the federal government had not assumed responsibility for its operation and for the promotion of recovery in 1933. However, it is clear that the degree of recovery from depression which was effected under governmental control was disappointing, and that the recovery was far from complete at the outbreak of the World War II.

Proposed Governmental Activities and Expenditures. In evaluating governmental activities and expenditures which are proposed for the post-war period, such as the guarantee of full employment, the provision of cradle-to-grave social security, and the underwriting of high minimum wages or minimum per capita incomes, it is not enough merely to compare the gain in satisfactions by the beneficiaries of these policies with the loss of satisfaction suffered by the taxpayers. As in the consideration of depression activities and expenditures, we must consider the effects on private businesses and industries, and on the economy as a whole. If, as some people think, an enthusiastic pursuit of the policies in question should make it

impossible for our economic system to operate in capitalistic fashion and transform it into some form of controlled and planned economy, we might experience several unpleasant changes. Such changes would conceivably include the loss of economic freedom which would probably be surrendered in a planned and controlled economy, the possible loss of political freedom, the difficulties which might arise because of a lack of adequate incentives in the planned economy, and other matters which will be discussed in the chapters on collectivism in the latter part of the present volume.

The danger that expanding governmental activities and expenditures may lead us in the direction of a planned and controlled economy is far from negligible. The public debt of the federal government amounted to about 279 billion dollars at the beginning of 1946. Interest on this debt at 2 per cent would amount to about 5½ billion dollars per year, and this would be merely the cost of carrying the debt. If any serious attempt were made to pay off the debt gradually, further large expenditures would be necessary. If the debt were not to be reduced in this fashion, it would have to be refinanced sooner or later and probably at higher rates of interest, which would have much the same effect on federal expenditures. Some persons who are relatively unconcerned about the size of the national debt seem to think that there is a limitless market for government bonds in this country at an interest rate of about 2 per cent; but we may doubt that this would be the case in peacetime and in a free market.

According to most pronouncements on the subject, our military and naval establishments, and the armed forces in general, will have to be maintained at a high level for some years to come, to protect us from unknown or unmentionable dangers and to enable us to play our part in international organizations for keeping the peace. The cost will surely run into several billions of dollars annually. We shall have other large expenditures for pensions, hospitalization, medical care, education, training, rehabilitation, and other projects undertaken for the benefit of veterans of World War II. Then we must add some billions of dollars for the operation of ordinary departments of government, others for an enlarged program of social security, and possibly still others for a federal guaranty of employment if full employment does not come about naturally. Some estimates of governmental expenditures for maintaining employment are as high as 10 or 15 billion dollars in some years—or even

year after year if there should be a chronic shortage of private spending for consumption and investment.

Just how large the annual expenditures of the federal government would be on the basis of these projects, and others which have been proposed, is uncertain, but most estimates call for federal expenditures far larger than those to which we have been accustomed in peacetime. Some persons are thinking in terms of only 18 or 20 billion dollars per year, but it is more likely that federal expenditures may run to 30, 35, or even 40 billions annually. Indeed, the federal budget for the peacetime fiscal year 1947 calls for federal expenditures of approximately 36 billion dollars. Whatever the annual amount might be, the large expenditures of the federal government in the post-war period would have to be financed by means of taxation if we did not wish to add steadily to the already overgrown federal debt. This would call for the continuation of very high levels of taxation, possibly not far removed from those which prevailed during the latter years of World War II.

The point we have been trying to make is that our economic system probably could not operate in capitalistic fashion in peacetime if the government should find it necessary to take a very large part of the earnings or "profits" of business enterprises of all types through taxation, while leaving these same enterprises to bear unassisted the greater part of any losses which they might encounter. Moreover, such a situation would be most unfavorable for the expansion of the economy and the foundation of new enterprises on the basis of private capital. And this discussion of public finance ignores the important direct question of whether the government could maintain full employment, a high and controlled level of wages, and a complete system of social security in any case without assuming full control over the operation of the economic system as a whole.

Public Borrowing and the Public Debt

The Growth of the Public Debt. The expenditures for carrying on governmental activities should ordinarily be made out of current revenues from taxation and other sources. In many years, however, all of our government units find it impossible to secure sufficient current revenue to meet their expenditures, and depend upon public borrowing to meet the deficit. Although the debts of state and local governments are also of significance, we shall center our

attention upon the public debt of our federal government. This debt reached $26,597,000,000 after World War I, but by 1930 it had been reduced to $16,026,000,000.[7] Since 1930, the federal government has had a large deficit every year and its debt has been mounting rapidly. It reached $40,440,000,000 in 1939, after nine years of deficit financing of depression activities. Then, with heavy national defense and war expenditures added to an already unbalanced budget, the debt grew rapidly to $136,696,000,000 in 1943, $201,003,000,000 in 1944, $258,682,000,000 in 1945, and $269,422,000,000 in 1946, as is shown in Table 12. The 1946 figure amounted to $1925 per capita.

TABLE 12. EXPENDITURES, REVENUES, DEFICITS, AND PUBLIC DEBT OF THE FEDERAL GOVERNMENT, FISCAL YEARS 1931–46 [a]

Year	Expenditures (in millions)	Revenues (in millions)	Deficits (in millions)	Public Debt (in millions)
1931	$ 3,652	$ 3,190	$ 462	$ 16,801
1932	4,535	2,006	2,529	19,487
1933	3,864	2,080	1,784	22,610
1934	6,011	3,116	2,896	27,053
1935	7,010	3,800	3,210	28,701
1936	8,666	4,116	4,550	33,779
1937	8,177	5,029	3,148	36,425
1938	7,239	5,855	1,384	37,165
1939	8,707	5,165	3,542	40,440
1940	8,998	5,387	3,611	42,968
1941	12,711	7,607	5,104	48,961
1942	32,397	12,799	19,598	72,422
1943	78,179	22,282	55,897	136,696
1944	93,744	44,149	49,595	201,003
1945	100,405	46,457	53,948	258,682
1946	65,019	43,038	21,981	269,422

[a] Sources: Board of Governors of the Federal Reserve System, *Banking and Monetary Statistics*, pp 509–510, 513, *Federal Reserve Bulletin*, February, 1946, pp. 171–173; *Report for the Business Executive*, August 8, 1946, p 2

Inflationary Dangers of Public Borrowing and an Increasing Public Debt. There can be no sound objection to governmental borrowing to meet an emergency, when revenues fall short. If a national emergency requires expenditures in excess of collectible revenues, the federal government would be foolish not to permit its budget to become unbalanced. When a man needs a surgical operation, he does not hesitate to call in the surgeon merely because the cost would unbalance his budget for that year. On the other hand,

[7] Daily Statement of the United States Treasury, June 30, 1941.

though the use of sulfa drugs may be indicated by pneumonia, they would scarcely prove beneficial as a steady diet. Continuing deficits of many billions of dollars per year may lead to the destruction of the government's credit. If the public debt grows so large that full payment of interest and repayment of principal become improbable, the government may eventually be unable to borrow from its people. If it is then unable or unwilling to decrease expenditures or increase ordinary revenues, it may resort to printing paper money with which to pay its bills. These inflationary tactics on the part of a government usually lead to an economic breakdown from which a country may not completely recover for many years.

In World War II our federal government did not resort to printing paper money in order to pay its bills, but it did something not very different. Anxious to make total expenditures far in excess of the sums which it was thought possible or feasible to collect in taxes or obtain from direct sales of bonds to the people, the government resorted to sales of bonds to the banks in order to obtain the necessary funds. The banks paid for these bonds by creating demand deposits for the government to spend. In this way the government obtained large sums of purchasing power without reducing the funds available for civilian spending, and the total of government and civilian purchasing power became much larger than necessary to take off the market at stable prices all the commodities and services the economy could produce. The situation which was created was about as inflationary as though paper money had been printed to finance governmental expenditures, except that the people apparently are not driven into as great a panic by the creation of demand deposits as by the printing of paper money. A tremendous inflation of prices was avoided during the war period by resorting to direct price control, production control, rationing, and other devices, but these measures merely postponed the problem and did not eliminate it.

The Future Burden of the Public Debt. Another objection to our rapidly growing public debt runs to the effect that we shall be passing on to our children and grandchildren a staggering burden of debt which they will have to pay, to their own great detriment. This contention is difficult to evaluate. Clearly, in the sense of *real income,* future generations may not suffer from a large public debt incurred now. If the government borrows to buy wheat to feed its starving people, the wheat is taken not from the crops of thirty or

fifty years hence, but from present supplies. If the government uses borrowed funds to induce farmers to plow cotton under, current crops (and not those which our children will harvest) are reduced. When the government spends billions of borrowed dollars for war goods, it causes a shortage of consumers' goods here and now, rather than in the more or less indefinite future.

What really happens when a government borrows directly from its people is that they are induced to turn over to it a part of their current money income. With these funds, the government is able to secure a larger share of our *present national real income* than it could otherwise obtain, and private individuals must get along with a smaller share than they would otherwise have. In the sense of real income, then, the cost of public borrowing is borne now in the form of a smaller real income for private purposes than would otherwise be available. And the effect may be much the same when the government borrows from the banks, instead of directly from the people, provided ways can be found to sterilize part of the large money incomes which remain in the hands of private individuals.

From the *financial* point of view, it is certainly true that the government will have to collect taxes in the future in order to pay interest on its obligations, and possibly to pay part of the principal, but at the same time these amounts will be paid to the owners of the government bonds which represent our public debt. If the people who own the bonds also pay the taxes, even private individuals may "break even" on the process. But whether certain *individuals* gain, lose, or break even, it is clear that the *nation as a whole*, in paying off the public debt, merely transfers money from one pocket to another so long as the entire debt is held within the country. Such transfers, it is said, should not be very harmful.

On the basis of these and other arguments, some writers are inclined to scoff at the idea that our large public debt will give us trouble in the future. The size of the debt is a matter of small importance, since "we owe it to ourselves." While individual bondholders will need to be paid off from time to time, the principal sum of the debt as a whole will never have to be paid and our only concern should be the size of the interest payments in relation to our national income. Indeed, some writers consider it desirable to have a continually growing public debt, on the ground that large governmental expenditures in excess of current revenues will insure the existence annually of a total sum of purchasing power in the

country large enough to take off the market all the commodities and services which the economy can produce at full employment. If we can keep the national income constantly growing in this way, even a total of interest payments which steadily increases in absolute size will not be a very severe burden.

In our opinion, however, a light-hearted attitude toward the future burden of the public debt is far from completely justified. When taxes are collected to pay interest on the debt or to repay principal, they may be so large in amount or be collected in such ways as to hamper and restrain production and employment and impair the effectiveness of our productive facilities. Indeed, these taxes may contribute significantly to a total burden of taxation which is so heavy that our economic system cannot support it and still operate in capitalistic fashion. Increases in the total of fixed income payments in the economy, such as interest payments on government bonds, tend to concentrate the risks of the system on those relatively few incomes which are drawn from the operation of business enterprises and the investment of venture capital. It has been estimated that the annual interest on a federal debt of 300 billion dollars would exceed the total of interest on private debts plus rents in a full-employment national income, and would equal one-fourth of the total business income (dividends, plus income of unincorporated businesses, plus agricultural income).[8]

With our banks and other financial institutions loaded with government bonds, a general rise in interest rates which would cause government bonds (with their low fixed rates of interest) to depreciate sharply in value would be a matter of serious concern. Finally, the political implications of having a large class of persons dependent upon interest on government bonds for a considerable part of their income may be anything but favorable. The size of the public debt *may* be a matter of considerable importance in the future, even though we do "owe it to ourselves."

The Control of Public Expenditures

In reaching a conclusion as to the proper extent of governmental functions and expenditures, the first matter to be decided is whether we want our economic system to operate in capitalistic fashion in the future. If we do not, there are no limits on governmental func-

[8] *Financing American Prosperity,* New York: Twentieth Century Fund, 1945, pp. 138, 139.

tions and expenditures. If we do, then governmental expenditures should be held down to a modest size in relation to the national income in ordinary years, the expenditures should be paid for out of taxation, and an effort should be made to reduce the public debt gradually. Moreover, we should bear in mind continually the direct relationship which exists between the functions of government and the cost of government.

The Need for a Changed Public Attitude. Our extravagance in handling public funds in the past may be traced in large part to the desire of individuals to get a full share of the seemingly inexhaustible store of wealth in the public treasury. Inefficiency and corruption in government flourish when the public attitude is one of indifference, if not condonation. It is necessary that the people be made to understand that there is no such thing as "government money" apart from the contributions of those individuals who support the government by the payment of taxes, fees, and the like. Every expenditure of public funds means inevitably a definite burden in the form of taxes, either currently or later.

When a person is heard to complain about the high taxes exacted by the federal government, he should be asked his attitude toward the leading activities and expenditures of this government. If he believes that these activities and expenditures are necessary and desirable, he should be willing to bear his fair share of their cost. Again, it is scarcely reasonable or patriotic for one to demand that government funds be spent in his district for the erection of a court house or a post office or for the widening of a creek unless he expects to contribute in tax payments to a fund that will enable other districts to have similar glorious but often quite unnecessary developments.

Indeed, as we have already pointed out, our legislators are able to obtain such appropriations for their districts only by cooperating with one another in a give-and-take fashion. Well-paved streets, magnificent highways, and ornate school buildings do not spring full-fledged from the ground. They can be constructed and maintained only at great expense, and this expense sooner or later must be borne by the taxpayers. Similarly, if the sight of human beings in want and misery causes a person's heart to bleed, so that he wishes them to be provided for by governmental action, he must remember that these functions of government will in the long run cause a drain upon his own purse. Surely a saner attitude toward

public finance on the part of the people of the country will follow an understanding of the relation between taxation and public expenditures, and go far toward bringing about efficiency in the appropriation and administration of the public funds.

Efficiency in Government. The nature and extent of the functions which the government is to perform having been decided, it is the part of wisdom for a people to insure that public expenditures shall not exceed those amounts which, with reasonable standards of efficiency, may be required to carry on these activities. Carelessness, inefficiency, and corruption should not be tolerated. To eliminate such evils, many writers on public finance recommend a reform of the budgetary mechanism to obtain a closer adjustment of appropriations to needs and to fix responsibility, changes in the Civil Service Laws to bring a more efficient system of governmental employment, provision of security of tenure and more adequate salaries in order to attract higher types of employees into the government service, and, in general, the introduction of sound business methods into the operation of governmental affairs.

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1. Why is it desirable to have certain services provided by governments rather than by private agencies?
2. What are the leading problems in connection with governmental functions and expenditures? Explain.
3. What has been the trend in recent years in the volume of expenditures made by the federal government? Explain the nature of the principal items of expenditure.
4. What has been the recent trend in the volume of expenditures made by state and local governments in the United States?
5. Compare the chief functions and expenditures of the federal government with those of state and local governments.
6. What relationship exists between the growth of population and the growth of public expenditures? Explain.
7. "A part of the increase in public expenditures in the United States in the twentieth century has been nominal, rather than real." What is the significance of this statement?
8. How does inefficiency in the appropriation and administration of public funds affect the total of public expenditures?
9. What is meant by "the popular attitude toward public money"?
10. How have economic and social changes been responsible for a part of the increase in governmental functions and expenditures?
11. What has been the influence of the growing spirit of humanitarianism upon governmental functions and expenditures? Why?

12. How did the great depression following 1929 affect governmental functions and expenditures? Explain.
13. Comment on the functions performed by the federal government during World War II, and those which have been proposed for the post-war period.
14. How can we reach a decision as to whether given individual functions should be performed by government? As to the appropriate total of governmental activities and expenditures?
15. In the light of the proposed test for public expenditures, how would you criticize the major items of expenditure of the various governmental units in this country in the past?
16. If, as some writers suggest, it is no less incorrect *economically* to speak of "winning a war" than to talk about "winning an earthquake," why is it that we spend so large a part of our national income for submarines, battleships, and bombing planes?
17. Comment on the necessity for the principal depression expenditures of our national government during the 1930's, in the light of the suggested test for public expenditures.
18. Evaluate the activities and expenditures which are proposed for the federal government in the post-war period.
19. "It is important to consider the indirect as well as the direct effects of governmental activities and expenditures." Explain.
20. Describe the growth of the public debt in recent years.
21. "There can be no sound objection to financing governmental expenditures through public borrowing." Discuss.
22. How may heavy public borrowing lead to inflation? Explain.
23. Is it true that the public debt of the federal government is certain to be burdenless in the future because "we owe it to ourselves"? Explain.
24. To what extent is it true that the burden of the public debt cannot be transferred to the citizens of future years? Explain.
25. "A light-hearted attitude toward the future burden of our large public debt is far from completely justified." Explain.
26. Why is there a need for a changed public attitude toward public functions and expenditures?
27. How should we seek efficiency in the conduct of government?

References for Further Reading

See list of references at the end of Chapter 10.

10. *Taxation*

Once it has been decided what functions shall be performed by governmental agencies, there remains the task of determining the method or methods of procuring the funds from which the proposed public expenditures may be made. At times the national governments have deemed it wise to manufacture their own purchasing power. In other words, they have printed large issues of inconvertible or "fiat" money which they have used in paying for the governmental functions. The effect of this additional purchasing power, competing with the money already in circulation for the existing supplies of commodities and services, has been to deprive the individual citizens of a part of their purchasing power just as effectively as if the governments had exacted tribute from these citizens in the first place.

As we noted in the preceding chapter, governments have commonly borrowed to obtain funds for public expenditures. This method has been used whenever it has appeared undesirable or impossible to obtain sufficient funds for current expenditures from current sources of revenue. By borrowing, we get government services in the present and pay for them on the installment plan over a long period of years. Occasionally certain units of government secure small amounts of revenue from the conduct of various public service enterprises, but this is not ordinarily an important source of public income.

The Nature of Taxation. The most important source of the funds from which public expenditures are made has been and will doubtless continue to be taxation. A tax is "a compulsory contribution from the person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred."[1] In connection with this definition several observations

[1] E. R. A. Seligman, *Essays in Taxation*, New York, The Macmillan Company, 9th ed., 1921, p. 432.

should be made. First, a tax is a compulsory contribution in that the amount to be paid is decided by the government, as are also the time and method of payment, without regard for the wishes of the individual taxpayer. In the second place, there is in taxation no definite *quid pro quo;* that is, the taxpayers are required to contribute to the support of the government on some basis other than the amount of benefit or service directly received by them from the government. It often happens that the persons called upon to pay the largest taxes are those who are least dependent on governmental services and who could best provide for themselves if the services in question were not performed by the government. Finally, the purpose of a tax is to provide revenue for carrying on various functions in the interest of the public. In this connection a serious question often arises as to whether a tax may properly be made the instrument for the accomplishment of some ulterior purpose, such as the reduction of existing inequalities of wealth and income.

The Problem of Taxation. Since all governmental units of the present day find it imperative to obtain the greater portion of their revenues from taxation, the problem of taxation becomes one of securing these necessary revenues in such manner as will, among other things, involve the smallest possible expense in collection and administration, interfere as little as possible with the conduct of business and economic progress, and distribute the burden of supporting the government in as equitable a manner as possible.

General Principles of Taxation

Fiscal Adequacy. Since the purpose of taxation is to provide large amounts of revenue for the different units of government, the first and most important test of a tax system is whether it will furnish sufficient revenue. The satisfaction of this test alone does not insure a perfect system of taxation, for many other important considerations must be borne in mind; but the inability to meet this test is of itself quite enough to make a tax system a failure. It matters little how convenient, economical, or simple the system is, or how well it succeeds in distributing the tax burden according to the high principles of equity and justice, if it does not provide the necessary revenue for the performance of the functions of government. Indeed, in times of great emergency—such, for example, as when a war is being waged—other factors are disregarded and the sole consideration of the government in passing upon tax rates and methods becomes that of fiscal adequacy.

Economy. As has been said, a tax system is set up in order to obtain a certain amount of revenue which is necessary for the performance of governmental functions. A sum must be collected from the taxpayers, however, which is larger than the amount to be spent by the government in question, in order to cover the costs of collecting and administering the taxes. Other things being equal, taxes which involve the collection of large increments of revenue, with a minimum of complaints and bookkeeping details to be handled, are preferable to those which necessitate the collection of a multitude of small sums and involve great complexity of administrative machinery. In the words of Adam Smith, "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state."

However, in connection with the test of economy, as well as with that of fiscal adequacy, the effects of taxation on the taxpayer and upon business in general must be considered. No tax is fiscally adequate, however great the revenue which it produces, and no tax is economical, however small its cost of collection and administration, if it is levied in such fashion or to such extent as to discourage business activity, curb individual initiative, or check unduly the accumulation of capital. It would be possible to devise a very simple system of taxation, the burden of which would rest entirely upon large incomes and large accumulations of wealth; but while this system might be a marvel of adequacy and economy for a time, its long-run results might easily be disastrous because of its effects on capital accumulation and business initiative. Almost everyone admits the validity of this principle, but there are great differences of opinion as to the exact point at which these undesirable effects would show themselves if higher and yet higher taxes were assessed on large incomes and great stores of wealth.

Simplicity, Certainty, and Convenience. Simplicity is another desirable feature of a tax system. The provisions of our tax laws should not be complicated, but should be so worded that they may readily be understood by those who must pay the taxes as well as those who administer the tax laws. It is scarcely likely that any system of taxation could be set up which would be understood in all its ramifications by all the taxpayers and officials concerned, but it is certain that our present laws leave room for a large measure of progress in the direction of simplification.

A sound tax system will also be characterized by certainty. It is

probable that our economic system could in the long run become adjusted to either a high or a low level of taxation with something like equal success, but uncertainty seems ever to be productive of undesirable results. Witness, for example, the effect of uncertainty as to the provisions of an impending tariff bill upon business activity in the United States! Uncertainty in taxation also provides many opportunities for chicanery and corruption in the assessment and collection of taxes.

Taxes should be collected at such times and in such a manner as will be most convenient for the taxpayers. It is not possible, of course, to have all taxes marked by convenience of payment, but we retain some taxes, such as those on commodities, which are very convenient to pay though they fall far short of perfection with regard to some of our other tests. In general, convenience of payment is a desirable quality whenever it can be obtained.

Elasticity. Writers on the subject of money and banking are in general agreement that one of the principal defects of our money and credit system prior to 1913 was its inelasticity. The quantity of money and credit could not be enlarged sufficiently to meet the emergency needs of business, and recurrent periods of monetary stringency and even financial panics resulted. Inelasticity is a serious defect in a system of taxation also, for it means that the revenue received from the taxes in operation cannot be expanded to meet the larger needs which may be experienced from time to time. Consequently, if the tax system lacks elasticity, there are likely to be frequent deficits and a dependence on borrowing to secure the funds with which to meet current obligations.

Equity. A final requisite for a sound tax system is that it shall be equitable. Once it is ascertained that a given system of taxation is likely to provide an adequate amount of revenue, the next most important consideration is to have the tax burden distributed among the taxpayers in an equitable manner. This consideration becomes increasingly significant as the size of the aggregate volume of taxation increases. Years ago, when public expenditures were relatively slight and the total burden of taxation was not heavy, almost any system was likely to be reasonably fair. This would not be true at the present time. In view of the importance of the principle of equity, it will be well to inquire further into its meaning as applied to a system of taxation.

The Benefit Theory of Taxation. Many persons have held in the past that a tax should not be defined as we have defined it, but

should be considered a payment to the government because of, and in proportion to, benefits received from it. Thus a person who benefited greatly at the hands of the government would be expected to pay a large sum in taxes, while one who derived but slight satisfaction from services rendered by it would not be asked to give any considerable portion of his income to its support. However, though the benefit principle seems very just in theory, it has been largely abandoned because of the apparent impossibility of applying it in practice. In the first place, it is not possible to determine exactly how much benefit each citizen receives from the government. Here we are dealing with the matter of individual satisfactions, which cannot be accurately appraised except by each for himself. In the second place, even if benefits could be correctly estimated, we might find that the persons receiving the largest benefits from the services rendered by the different governmental units were the very ones who were least able to spare any great amount in taxes to pay the costs of such services. On the other hand, as we have already said, those with very large means might well be able to provide for themselves many services now rendered by the various governmental units. Thus they would be less dependent than the poor upon these services, and could not be called upon to make any large contributions to the government on the basis of the benefit principle.

The Principle of Ability to Pay. Most economists and writers on public finance at the present time have gone over to the principle of ability to pay, which holds that each individual should be taxed, for the most part, according to his ability to make contributions to the support of the state, without regard to the amount of benefit he may derive from the activities of the government. This principle seems on the surface to be admirably simple, but its interpretation is extremely difficult. What, for example, shall be the test of ability to pay? The answer to this question used to be that the possession of property was a clear indication of ability to pay taxes, and it was decided that any man who was fortunate enough to own great quantities of wealth should be required to contribute large amounts to the governmental treasuries. As time went on, economists came to suspect that some modification of this answer was necessary, for many individuals were receiving large incomes annually but were escaping the tax-gatherer altogether under the prevailing system of general property taxes.

Income as an Indicator of Ability to Pay Taxes. It may be said that today the greatest emphasis is placed upon income as a test

of ability to pay, although property is by no means completely disregarded in this connection. This does not mean, however, that it is necessary merely to discover the amount of a person's income in order to pass judgment on his ability to pay taxes. Many other matters must be borne in mind, such as whether the income in question is "earned" or is derived from investments, whether it contains any elements such as the return on diminishing assets, whether it represents any surplus over and above the returns necessary to induce the individual to continue to perform his services or lend his capital, and, finally, the length of time over which the income is received.

Proportion vs. Progression. Probably the most important question in connection with the principle of ability to pay relates to the way this ability increases as income increases. In other words, as a man's net taxable income increases, does his ability to pay taxes increase exactly in proportion to this increase, or more or less slowly? If A has a net taxable income of $10,000, while that of B is $5000, is A able to pay exactly twice as much in taxes as B, more than twice as much, or less than twice as much, supposing the considerations mentioned in the preceding paragraph to be the same for both individuals? These are questions that can be answered only after a further examination of the meaning of the principle of ability to pay. If we decide that A's ability to pay is exactly twice as great as B's, then taxation should be proportional—that is, the same rate should apply to both individuals—and at this rate A's contribution will be double that of B. If A has less than twice the ability of B to pay taxes, the rates of taxation should be regressive, that is, a lower rate should apply to the larger incomes than to the smaller. Finally, if A's ability to pay taxes is more than double that of B, the rates of taxation should be progressive, that is, the greater the income the higher the rate of taxation which is applicable to it.

The advocates of progressive taxation base their arguments in large measure on the theory that the satisfaction to be derived from the expenditure of a unit of money income diminishes as the total income of the spender increases. A certain amount of income is necessary as a minimum for subsistence, and does not represent ability to pay in the true sense of the term. The first increments of income above this minimum amount are used by the individual to satisfy urgent wants, while further and yet further additions to income will be used to satisfy less and still less important wants. It follows that, unless we are dealing with individuals who choose to

satisfy their less pressing desires before attending to those which are more urgent, diminishing satisfaction is experienced in the expenditure of successive increments of income. Thus, it is held that the man with an income of a million dollars a year is not losing nearly so much satisfaction when compelled to give up one hundred thousand dollars in taxes as is the man with ten thousand a year when he contributes a thousand dollars to the support of the government, although it is clear that the rate is the same in these two instances. It may seem equitable, then, for the recipients of large net taxable incomes to pay taxes at higher rates than those applied to men receiving smaller incomes, which means, of course, the use of progressive rates of taxation.

Since there is no way to make accurate direct comparisons of utilities or satisfactions between different individuals, and since it is by no means certain that all individuals have equal capacities for experiencing satisfactions, it is impossible to *prove* that this analysis in support of progressive taxation is sound. However, most students of public finance are satisfied that progressive rates of taxation should be used wherever they can be successfully applied—which means for all practical purposes in the taxation of incomes and inheritances. It should be apparent that a progressive tax upon a commodity, say cigarettes, which would mean a high tax if the purchaser were rich and a low tax if he were poor, would not be practicable. Once it is decided that taxes should be progressive where possible, there remains the problem of deciding how progressive they should be, and here we must consider the indirect as well as the direct effects of taxation. That is to say, taxes might be made so highly progressive that they would discourage business activity, curb individual initiative, and check unduly the accumulation of capital.

The Incidence of Taxation. In deciding whether a particular tax system is equitable, it is of vital importance to know who ultimately bears the burden of the various taxes levied. It has long been customary to divide taxes into two classes, direct and indirect. *Direct taxes* are those which are collected at the outset from the persons upon whom it is intended that the burden shall fall, such as a tax on the rent of land. *Indirect taxes* are those collected from one group of individuals with the expectation that the burden will be shifted by them to a different group. The classification of taxes into direct and indirect groups has proved to be unfortunate. In some

cases, we find so-called direct taxes being passed on, in part at least, to others than those from whom the tax was originally collected, while at other times so-called indirect taxes have not been shifted, but have remained a burden upon those who paid them in the first place. Wholly apart from any classification, however, the problem of the "incidence," or ultimate burden, of taxation is extremely important.

The study of the shifting and incidence of taxation is a branch of the study of value. To know whether a tax on a given commodity is likely to be shifted, it is necessary to ascertain whether the conditions of production and sale for that commodity make it possible for its price to be raised so as to pass the amount of the tax on to the consumers, or for the tax burden to be passed backward to the suppliers of certain productive agents in the form of lower prices. If the tax in question is levied on some agent of production, such as land or capital, it is necessary to make a similar investigation into the conditions which determine the price of that agent of production, in order to discover whether the tax can or cannot be shifted.

The Federal Revenue System

As may be seen in Table 13, the federal government had a total revenue of $47,740,000,000 in the fiscal year 1945, and a total net revenue of $46,457,000,000. The comparable figures for 1941 were $8,461,000,000 and $7,607,000,000. Of the total revenue in 1945, the personal income tax yielded 39.4 per cent; all corporation taxes, 34.8 per cent; payroll taxes, 3.8 per cent; estate and gift taxes, 1.3 per cent; excise taxes, 12.5 per cent; customs duties, 0.7 per cent, and non-tax sources, 7.5 per cent. These figures may be compared with those for 1941, when the personal income tax yielded 16.6 per cent; corporation taxes, 26.3 per cent; payroll taxes, 10.9 per cent; estate and gift taxes, 4.8 per cent; excise taxes, 28.4 per cent; customs duties, 4.6 per cent; and non-tax sources, 8.4 per cent. We shall now turn to an examination of these several types of taxes. (Preliminary figures for the fiscal year 1946 indicate that the federal government had total revenues of $44,239,000,000, including $18,331,000,000 from the personal income tax, $12,554,000,000 from corporate income and excess profits taxes, $1,714,000,000 from payroll taxes, $7,725,000,000 from excises and other sources of internal revenue, and $3,915,000,000 from customs duties and miscellaneous receipts.)

TABLE 13. SOURCES OF FEDERAL REVENUE, FISCAL YEARS 1941 AND 1945 [a]

Source of Revenue	Amount Received in 1941 (in millions)	Per Cent of Total Revenue, 1941	Amount Received in 1945 (in millions)	Per Cent of Total Revenue, 1945
Personal income	$1,418	16.6	$18,831	39.4
Corporation income tax	1,852	21.9	5,083	10.6
Excess profits taxes	201	2.4	11,148	23.4
Capital stock tax	167	2.0	372	0.8
Payroll taxes	926	10.9	1,793	3.8
Estate and gift taxes	407	4.8	643	1.3
Excise taxes	2,399	28.4	5,945	12.5
Customs duties	391	4.6	355	0.7
Non-tax revenue	700	8.4	3,570	7.5
Total revenue	$8,461	100.0	$47,740	100.0
Transfers to trust funds (deduct)	854		1,283	
Total net revenue	$7,607		$46,457	

[a] Sources: *Federal Reserve Bulletin*, October, 1945, p. 1047; United States Treasury Department statements of August 18, 1941, and August 1, 1945.

The Personal Income Tax. The taxation of personal incomes was the most important source of federal revenue in 1945. In applying the tax, after the deduction from gross income of the necessary expenses of acquiring it and certain other allowable deductions, an exemption of $500 was allowed the individual taxpayer against the normal tax, which was applied at the rate of 3 per cent to the rest of his income. Against the surtaxes, or additional taxes which made the personal income tax progressive, the individual taxpayer was allowed an exemption of $500 for himself and $500 more for each dependent. The surtaxes began at 20 per cent on the first $2000 of eligible income, and reached a maximum of 91 per cent on all income in excess of $200,000 above the exemptions. The total of normal tax and surtax was limited to 90 per cent of net income.[2]

In 1945, normal taxes and surtaxes on wages and salaries of $5000

[2] The Revenue Act of 1945, effective January 1, 1946, changed the personal income tax to some extent. Exemptions for taxpayers and their dependents were made as large for normal tax purposes as for surtax purposes, surtax rates were lowered 3 points in each income bracket, and the tax liability of each taxpayer was reduced to 95 per cent of his total tax, as computed.

or less were being withheld by employers and paid directly to the government. Individuals with incomes of more than $5000 from wages and salaries, or with incomes of more than $100 from other sources (providing the total income was at least $500), had to file an estimate, by March 15, of their total tax liability, the amount of tax which would be withheld from them, and their net tax liability to the government. One-fourth of the latter sum had to be paid at once, and the remainder in three installments on June 15 and September 15, 1945, and January 15, 1946. Then, by March 15, 1946, all payers of the personal income tax had to file a final return, adjusting their actual tax liability to the payments which had been made during the year by withholding or otherwise.

Merits of the Personal Income Tax. The personal income tax is generally considered to be a good tax. It falls directly on income, from which all taxes must come eventually, if sometimes indirectly; and income is the most widely accepted indicator of ability to pay. The tax usually yields a large revenue but, being based on realized income, the receipts are likely to decline sharply in times of business depression when the government needs especially large revenues. The tax lends itself readily to progressive rates, which are usually thought necessary to the application of the principle of ability to pay. It is certain as to time and manner of payment, but is only moderately satisfactory from the point of view of economy in collection. Finally, because of the progressive rates of the personal income tax, the collection of a given amount of revenue by means of this tax tends to inhibit consumption expenditures to a lesser extent than would the collection of the same amount of revenue by means of excise or payroll taxes, which bear directly on income destined for consumption.

Defects of the Personal Income Tax. Although repeated attempts have been made to simplify income tax procedure for the small taxpayers, the personal income tax law remains complicated, and a person of considerable income often needs legal advice in arriving at the amount of tax he must pay. Except for the withholding of the tax on wages or salaries of $5000 or less, the method of assessment is by the taxpayer's declaration of his income, expenses, and deductions, supplemented by information (furnished by employers and others who make the payments) as to amounts paid in salary, interest, or other types of income. This method of assessment requires a high degree of administrative efficiency if the tax is not to be

merely a tax on honesty and to lead to widespread evasion.

It is difficult to define income for purposes of taxation, and our laws do little more in this respect than to enumerate various taxable and non-taxable items. Under the law, as now interpreted, some peculiar situations arise. For example, a farmer need not count as taxable income the food and shelter provided by his farm, but no similar privilege is accorded those who must buy their food and shelter with money income. A house owner who occupies his house need not count as taxable income the shelter he enjoys, but if he rents the house to another the rental that he receives is taxable. If a man is buying a house through payments over a long period of time, the interest that he pays on his indebtedness is deductible from income for tax purposes, but he has no such deduction if he buys the house outright for cash. If the individual owns a corporate bond, the interest received is subject to the income tax, but the same thing is not true if he owns a "tax-exempt" bond issued by some governmental unit in the past.

Another difficulty in connection with the personal income tax is found in the treatment of capital gains derived from the sale or exchange of assets. If a taxpayer's surtax net income is less than $16,000, net long-term capital gains must be included in ordinary income, and will be subject to a combined normal tax and surtax of from 25 to 50 per cent (under the law in effect in 1945). However, since only 50 per cent of long-term capital gains need be counted as income, the *effective* rate of taxation for these gains is from 12½ to 25 per cent. If the taxpayer's surtax net income is $16,000 or more, he is allowed to pay a flat tax of 50 per cent on the net long-term capital gain reported, but the amount reported as income is only 50 per cent of the actual gain, so that the effective rate of taxation is 25 per cent. Thus, long-term capital gains are never subject to an effective rate of taxation higher than 25 per cent, and the rate may be substantially lower.

This preferential treatment of capital gains interferes considerably with the progressiveness of the personal income tax, for capital gains are likely to constitute a larger part of the total income in the higher than in the lower surtax brackets. Moreover, it is sometimes possible to convert other types of income into capital gains in order to avoid paying high surtax rates. If, for example, one is selling, at a profit, a capital asset that is to be paid for on the installment plan, with interest to be paid by the buyer, it may be better to add the

total amount of the interest to the price of the asset (so that it will appear as a capital gain) than to have interest as such paid with each installment of the principal. The reason is, of course, that interest as such is subject to the full normal tax and surtax, whereas the effective rate of taxation applicable to long-term capital gains cannot exceed 25 per cent. Finally, the preferential treatment of capital gains applies to gains from purely financial speculation and other sources, as well as to those which often form an important part of the profits from new ventures in business or industry.

The most serious defect of the personal income tax, under the present highly progressive rates, is its effect in discouraging enterprise and personal initiative. In combination with taxes on corporate income, it imposes heavy double taxation on income derived from corporate ownership. By itself, it discourages self-employment by individuals and the founding of unincorporated enterprises. The income from business ownership is always uncertain, and this is especially true of the income from new ventures; yet the personal income tax takes a considerable part of any net income received, and it permits only a relatively meager offset for losses. The tax is especially restrictive for individuals who already have large incomes. Why should the movie star undertake another picture this year if all the additional income derived from it will be subject to an 88 per cent tax, and why should the well-to-do individual undertake a new and risky business venture under the same circumstances?

The Incidence of the Personal Income Tax. The usual conclusion with regard to the incidence of the personal income tax is that its burden remains on those who pay it and that it cannot be shifted. It is argued that there is nothing about the income tax that enables individuals or companies to raise the prices of the goods they are selling, or makes the personal services or the capital furnished by individuals command a higher return. Consequently, it is said, all efforts to pass personal income taxes on to others are doomed to failure. This is undoubtedly a sound conclusion so far as the individual taxpayer is concerned. However, in the long run, if enough people were discouraged from undertaking business ventures or entering high-paying occupations, those who still did these things might obtain large enough incomes so that, after paying the tax, they would have as much income left as they would have had in a previous situation in which the tax had not yet been imposed.

Taxes on Corporations. The corporation income tax produced 10.6 per cent of the total federal revenues in 1945. The normal tax rate was 24 per cent for corporations with net incomes in excess of $25,000, and 15 to 19 per cent for corporations with smaller net incomes.[3] The surtax was 16 per cent for corporations with net incomes in excess of $50,000. Corporations with net incomes between $25,000 and $50,000 paid 10 per cent surtax on the first $25,000 and 22 per cent of the balance, and corporations with a net income of less than $25,000 paid a straight 10 per cent surtax.[4]

Excess profits taxes produced 23.4 per cent of the total federal revenues in 1945. Most of this revenue was yielded by the excess profits tax applied in 1940 (sometimes called the "main" excess profits tax to distinguish it from the "declared value" excess profits tax). For the purposes of this tax, each corporation received a flat exemption of $10,000, plus a further credit computed by either of two methods —net income or invested capital. By the net income method, the credit amounted to 95 per cent of the average net income of the corporation in the period 1936–39, plus 8 per cent of net capital additions or minus 6 per cent of net capital reductions. By the invested capital method, the credit was 8 per cent of invested capital up to 5 million dollars and 7 per cent of invested capital over 5 million dollars. After the deduction of the exemption and the credit, each corporation (unless specifically exempted by law) paid the excess profits tax on the remainder of its income at the rate of 95 per cent. Ten per cent of the tax was to be refunded after the war.[5]

In addition to the taxes already described, the capital stock tax and declared value excess profits tax fell on corporate incomes in 1945, though they produced relatively little revenue. These taxes had been paired as complementary taxes since 1943. The rate of the capital stock tax was $1.25 per $1000 of the declared value of each corporation's capital stock. Having declared a total value for its capital stock, a corporation could earn 10 per cent on this value without paying any declared value excess profits tax. How-

[3] The normal tax applied only to corporate net income which was not subject to the main excess profits tax.

[4] The Revenue Act of 1945 reduced surtaxes on corporate income by amounts ranging from 2 per cent for corporations with net incomes in excess of $50,000 to 4 per cent for corporations with net incomes of less than $25,000.

[5] The main excess profits tax was repealed by the Revenue Act of 1945, effective January 1, 1946.

ever, it had to pay 6.6 per cent on net earnings of 10 to 15 per cent, and 13.2 per cent on net income in excess of 15 per cent, of the total declared value of its capital stock.[6] Under these various taxes on corporations, as described, it would seem that a corporation might have to pay more than 100 per cent of its net income in taxes to the federal government, but such disasters were forestalled by a general proviso that all corporate taxes together must not take over 80 per cent of any corporation's net income.

Evaluation of Taxes on Corporate Income. The corporation income tax has usually been a good revenue producer although, like the personal income tax, its yield diminishes greatly in poor business years. This tax is not open to some of the objections urged against the personal income tax, though in the case of both it is difficult to decide what constitutes net income. Excess profits taxes also amount to very little in years when the level of economic activity is low or moderate, but they produce large amounts of revenue in prosperous years, and especially in wartime, when they are useful in preventing war profiteering. Excess profits taxes are often complicated, for it is very difficult to make them both fair and simple. They often give rise to extensive litigation and impose a severe test on the federal administrative machinery.

The various taxes on corporate incomes, considered together, are subject to certain criticisms, noteworthy among which is the suggestion that they do not conform to the principle of ability to pay. Many people contend that a corporation has no ability to pay taxes apart from the ability of its stockholders to pay. If this is true, we must note that the size of a corporation's net income has no necessary relationship to its stockholders' ability to pay taxes. One corporation with a moderate net income may distribute it in large amounts to its few (and possibly well-to-do) stockholders, while another with a huge net income may pay this income in small driblets to its hundreds of thousands of small stockholders. In such a case, a small tax on the former corporation's income and a heavy tax on the latter's will not cause the respective stockholders to give up income in accordance with the principle of ability to pay.

It is also commonly held that taxes on corporate income, in combination with the personal income tax, lead to double taxation of the same income. When the corporation receives net income, it pays

[6] The capital stock tax and declared value excess profits tax were repealed by the Revenue Act of 1945.

the corporation income taxes, and any other levies on corporate income which may be in effect at the time, and then pays dividends to the stockholders. The dividends then become personal income to the stockholders and are subject to both the normal personal income tax and the surtax, if the stockholders' incomes are sufficiently large. This is unquestionably double taxation and it penalizes severely the income drawn from corporate ownership as compared with other types of personal income. This criticism still applies, though with somewhat reduced force, now that the excess profits taxes have been abolished.

The Incidence of Taxes on Corporate Income. The above argument concerning double taxation assumes that taxes on corporate income cannot be shifted forward to consumers of corporate products or backward to the owners of productive agents used by corporations, but remain as a burden on the corporation and its owners. This assumption is probably valid for most practical purposes, since the taxes in question fall on the net income realized from business operations in a given period and do not affect directly the marginal costs of the firms or give them any direct ability to raise prices. If any shifting of the tax occurred, it would be over long periods of time and in industries made up largely of corporations and not severely regulated by the government. The process would involve the lowering of the attractiveness of investments in corporate enterprises and reducing investment, with the result that surviving corporate firms could get higher prices and possibly as much net income as before the heavy taxes were applied. Any shifting that occurred in the long run would not, of course, alter the fact that double taxation had existed in the meantime.

Payroll Taxes. In 1945, payroll taxes produced 3.8 per cent of the total revenue of the federal government. These taxes are collected for the accumulation of reserves required under the Social Security and Railroad Retirement Acts. The taxes levied under the Social Security Act have been described in Chapters 5 and 6. Considering payroll taxes from the point of view of public finance, we suggest that those which fall on the employees operate as a crude sort of income tax, for all employees who come under the Act pay the same percentage of their wages. The taxes paid in the first instance by the employers will tend to be shifted to either the workers or the consumers, and will be regressive in operation. It would probably be better, from the point of view of equity, to support the various

old age and unemployment projects out of general revenues, but the tax-consciousness promoted by payroll taxes may be desirable.

Estate and Gift Taxes. The combination of estate and gift taxes produced only 1.3 per cent of the total federal revenues in 1945. The estate tax is applied to estates as a whole rather than to shares received by individual heirs. The first $60,000 of an estate is exempt, and the tax rates in 1945 ranged from 3 per cent on the parts of estates which barely exceeded the exemption, to 77 per cent on the parts of estates in excess of $10,000,000. Credit was given against the federal estate tax for 80 per cent of any amount which was paid in taxes under state inheritance tax laws. The gift tax, which is necessary to prevent evasion of the estate tax through transfers of wealth between living individuals, had rates three-fourths as great as the estate tax rates.

The estate and gift taxes can be relied upon to produce a fair amount of revenue, but they are not a good source of increased revenue if the increase must be made available suddenly. The estate tax unquestionably accords with the principle of ability to pay. Inherited wealth is purely a surplus return to the heir, and is entirely unearned by him. The greater the amount that society permits to be passed on through inheritance, the greater is the share which society may legitimately claim from an estate. The incidence of the tax is clear. Its burden rests wholly upon the receivers of the estate and cannot be shifted. The tax is certain as to amount, and as to time and manner of payment.

Objections to Estate Taxes. There are, however, at least two possible objections to the estate tax which the government should be careful to meet. In the first place, it is argued that, if the tax is too high, it will lessen the efficiency of business men and slow down the process of saving and capital formation. It is said that one of the strongest motives for working to acquire a large income, and for saving and accumulating a fortune, is the desire to provide adequately for one's dependents. If the inheritance tax is very high, some men might not seek to acquire large incomes, or might spend them for current enjoyment, and as a consequence the vital process of saving and capital formation would languish.

There is undoubtedly some truth in this contention. The desire to provide adequately for dependents is one reason why men work, save, and accumulate. However, there are many other motives operating in the same direction, such as the desire for luxurious living,

the wish to provide for one's old age, and a yearning for prestige and power; so that capital formation probably would not cease even if inheritance were entirely eliminated. In any case, the present federal taxation of estates is not likely to have any detrimental effects upon our economic system, for $60,000 may be passed on free of tax, and estates of even $100,000 or $200,000 are not greatly reduced by the tax. Indeed, some authorities on taxation urge that the estate tax rates should be increased and the exemptions lowered, with particularly high taxes applied to properties which were inherited twice or oftener. It is urged, also, that gift tax rates in the lower brackets should be raised, so that they will no longer provide so attractive a means of evading the higher rates of the estate tax.

Another objection to an estate tax is its inconvenience in payment. Many estates are left largely in the form of real estate, factories, machinery, and securities, and not in cash. Unless the heirs have other large sources of income, they may have to liquidate the inherited properties to pay the tax and, at a forced sale, might have to sell at a considerable loss. In this way, an heir might lose 40 or 50 per cent of the value of an estate on which the estate tax was only 25 per cent. This objection is taken care of, to some extent, by granting a reasonable period of time within which to pay the tax, and by providing for the revaluation of an estate if its value has declined between the date of death of the decedent and the date on which the tax must be paid.

Excise Taxes. In 1945, excise taxes of various kinds produced 12.5 per cent of the total revenues of the federal government. Excise taxes are taxes on economic goods. In some cases, producers are required to buy and affix stamps to the articles they make and sell. Again, the producers may be required merely to pay the government a certain amount per unit of product produced and sold. Some of the taxes are specific, as for example a tax of (say) 5 cents per package of 20 cigarettes; others are ad valorem taxes, such as a tax of 10 per cent on the factory price of automobiles.

The Incidence of Excise Taxes. While excise taxes are usually collected from the producer in the first instance, their burden is borne in the end by the ultimate consumer when the taxed goods are made under competitive conditions. The tax is shifted through increases in the prices of the taxed articles, for excise taxes are costs of production to the producers of the goods and must be covered by price if production is to continue. However, the process of shift-

ing is not the simple one of adding the taxes to the old prices. According to the Law of Demand, an attempt to raise the price of a taxed article will decrease the volume of sales. The extent to which an increased price will curb sales depends upon the elasticity or inelasticity of demand, but some decrease in sales is inevitable if the total demand for the good remains the same as before. A decreased volume of sales results in a decreased output of the good, and this change of output is likely to cause a change in the manufacturing costs of producing the good in the period of current production. Since the new manufacturing cost may be either higher or lower than before, depending upon whether the former output was greater than, equal to, or less than normal capacity, the price of the taxed article may increase by either more or less than the amount of the tax, in the process of shifting the tax to consumers. The effect upon price also depends to some extent upon whether the tax is specific or ad valorem.

Under conditions of monopoly, partial monopoly, or imperfect competition, the shifting of excise taxes is less certain than under competition. The monopolist or partial monopolist does not care who pays the excise taxes. His only concern is to set output and price at figures which will bring him the greatest possible total net revenue from the production and sale of his good. In some cases, his former output and price may have been so much more profitable than any other combination of output and price that he will be better off in terms of total net revenue to leave both unchanged and bear the tax himself, instead of attempting to shift it to consumers by raising price and reducing output. In other cases, a new combination of output and price would doubtless be more profitable than the old one, after the imposition of the tax, and as a consequence the monopolist would raise price and decrease output.

The Merits and Demerits of Excise Taxes. In general, the burden of taxes on commodities and other economic goods, no matter where it is first placed, tends finally to fall as a whole or in large part upon the consumers. Because of this fact, these taxes, judged by themselves, do great violence to our principle of ability to pay. They are not progressive, nor are they even proportional to income. People with large incomes pay these taxes in greater absolute amounts than people with small incomes, but the percentage of total income spent for economic goods subject to excise taxes tends to decline as a person's total income increases. Therefore, these

taxes take away a smaller *percentage* of a large than of a small income, and are regressive in operation. This does not mean that they should never be imposed, for their bad effects may be quite offset by other taxes in the system. Excise taxes have been good revenue producers in the past, and have been considered a rather elastic element in the tax system. Their convenience in collection and payment is well known, for they "get the feathers with a minimum of squawking." They are often included in the prices of articles in such a way that most consumers are unaware that they are paying them.

Customs Duties. Customs duties, or duties on imports, produced less than one per cent of the total federal revenue in 1945. These taxes have lost importance rapidly, for at one time they produced almost all the revenue of the federal government. With the United States operating under a high protective tariff, revenue from import duties is largely incidental. The main purpose of the tariff is to protect American industries by excluding foreign products from our markets, and a protective tariff which was completely successful in this respect would produce no revenue. Import duties paid on commodities from abroad ordinarily have the same incidence as taxes on the production of domestic commodities; that is, they fall on the final consumers. Hence, these taxes may be criticized in much the same terms as those applied to excise taxes above, except that the fiscal adequacy of customs duties is more seriously open to question than that of excise taxes.

The Federal Tax System as a Whole. In some respects, it is difficult to summarize our study of the federal tax system. Some of its taxes are direct, others are indirect. Some are convenient and economical to collect, others are not. Some are progressive, others are regressive. Certain generalizations may be made, however. The federal tax system as a whole ordinarily meets fairly well the test of fiscal adequacy. In depression or war years, of course, it sometimes fails to provide enough revenue to cover all expenditures which must be made, but it is difficult to imagine a tax system that would be perfectly elastic and adequate for all emergencies. In 1945, about 75 per cent of the total federal revenue was derived from taxes which were progressive, at least nominally. In the case of taxes on corporate incomes, however, there is no certainty that the progressive rates actually levied are converted into progressive rates on the incomes of the individual owners of corporations.

The federal tax system as it existed in 1945 may have been necessary or even desirable for purposes of war finance, but it would be open to serious objection in time of peace because of its probable effects in restricting production and employment, and discouraging business ownership and the founding of new enterprises. The heavy excess profits taxes used in 1945 would have no place in a peacetime tax system, for they would deprive many firms of any incentive to do more business than had been done in the base period, and would place grave difficulties in the way of new firms which needed to increase their capital out of earnings. The excess profits taxes have been repealed, of course, but a number of further changes in the federal tax system would be desirable.

Proposed Changes in Federal Taxation. Excise and other nonprogressive taxes may be necessary in years of unusually heavy expenditures, but the goal should be to collect from income and estate taxes as large a part as possible of the total federal revenue. In particular, the personal income tax should be the mainstay of federal taxation. For this purpose, it would be necessary that exemptions in connection with this tax be kept at a low level, and that surtax rates progress sharply in the middle income brackets, or up to the level of (say) $20,000.

Moreover, heavy dependence on income taxes in general would seem to require a number of changes in the application of the taxes. For one thing, complete offsets for losses against taxable income earned in earlier or later periods would be desirable in order to reduce as much as possible the deterrent effects of income taxes on investment. If income is taxed without offsets for losses being provided, risky investments are discriminated against, since they involve the greatest possibility of losses. A carry-forward period of six years and a carry-back period of two years would probably be adequate to provide complete offsets for losses for well-established firms and well-to-do individuals, but these provisions would not help unsuccessful new corporations which do not have any net taxable income in other periods against which losses could be offset. In such cases it might be desirable to have the federal Treasury pay the firms a fraction of their losses equal to the fraction which the Treasury would have taken out of net taxable incomes of the same size. That is, if a new firm would have to pay a tax of 20 per cent on a net income of $20,000, then the Treasury would pay the firm 20 per cent on a net loss of $20,000.

In the second place, the application of progressive rates of taxation discriminates against incomes which are irregular through time. Thus, an individual who had an income of $50,000 in one year and then $12,500 a year for the next four years would pay a much higher total tax over the five-year period than another individual with the same total income over the period who received $20,000 each year. Considerations of equity would seem to require that the two individuals pay the same tax on the same total income over the given period. Relief could be given by allowing the taxpayer to recompute his tax liability on an average income basis at five-year intervals and secure a refund of the difference between this tax liability and the amounts of taxes actually paid. A similar averaging principle might also be applied to exemptions, and to capital gains and losses. In the latter case, the averaging period should be equal to the number of years for which an asset was held prior to the realization of a gain or loss, and such averaged gains or losses could then be figured in fairly with ordinary income.

Third, small new firms are subjected to great difficulties when they are taxed at the same rates as large, well-established firms. Our tax laws should not discriminate against the former firms; on the contrary, quite possibly they should discriminate in their favor. It might be well to exempt corporate incomes up to $25,000 from the corporation income tax, and possibly to treat small corporations as partnerships. Research expenditures should be defined liberally and treated as current expenses which could be used to offset current income. Along the same line, in the case of the personal income tax it would be desirable to employ differential tax rates, so that personal incomes derived from self-employment (operating enterprises) and from corporate dividends would be taxed less heavily than personal incomes derived from salaries or interest. And personal incomes invested in new plant and equipment, or in corporate stocks for the same purpose, might well be taxed at less than the regular surtax rates. The purpose of all these provisions would be to stimulate production, employment, business ownership, and particularly the founding and growth of new enterprises, while maintaining a high level of revenue for the federal government.

Fourth, the tax exemption privilege now accorded to interest on the bonds issued by state and local governments should be eliminated. At present, as has been said, "This exemption privilege is not only highly inequitable and costly to the Treasury but acts as a

major deterrent to risk-taking. A wealthy taxpayer who is subject to a surtax rate of 65 per cent, for instance, will find investment in a tax-exempt 4 per cent bond equivalent to investment in a taxable venture paying 12 per cent before tax, quite apart from avoiding the risks of the higher yield security. The tax advantage of gilt-edged investment, and the relative disadvantage of risk investment, moreover, are greater the higher the surtax bracket. Risk investment, therefore, is deterred most at the very source from which venture capital should be expected to flow."[7] This situation should be corrected immediately.

Fifth, community-property provisions and the option which husbands and wives now have of filing separate or joint returns should also be eliminated. In certain states, the income received by husband and wife is now regarded as community property. Each may lay claim to half the income and file a separate return, which results in a great saving in terms of income taxes. In the other states, husbands and wives may claim only the income which they receive individually, but they may file either joint or separate returns so as to minimize their total income tax.

Finally, there is need for integration of the personal and corporate income taxes in order to avoid some of the difficulties mentioned earlier in this chapter. One proposal would abolish the tax on corporation incomes and bring these incomes under the personal income tax. This might be done by requiring every individual to declare annually, as part of his personal income, his proportionate share in the earnings of any corporations in which he was a stockholder, regardless of whether these earnings were or were not distributed to the stockholders. This would do away with double taxation as between corporate and personal income taxes, and would eliminate the troublesome question of whether a corporation has ability to pay taxes apart from the ability of its individual stockholders. If this proposal were considered too formidable from an administrative point of view, corporations might be allowed to deduct from their own taxable incomes all or part of the cash (or stock) dividends paid to the stockholders; or corporations might be taxed in full on their incomes, the individual stockholders being permitted to credit the taxes paid for them by the corporations against their personal income tax liabilities.

[7] Board of Governors of the Federal Reserve System, *Public Finance and Full Employment,* Postwar Economic Studies No. 3, Washington, 1945, p. 37.

Apart from the changes which have been suggested in connection with income taxation, an attempt should be made to strengthen the estate tax. The estate and gift taxes should be coordinated more closely in order to prevent evasion of the estate tax through gifts in anticipation of death. The means of escape now provided by the tax-free transfer of life estates should be eliminated. The exemption might well be reduced somewhat from its present level of $60,000 and the rates of taxation may need some revision.

State Revenues

The state governments of the United States are like the federal government in being dependent primarily on taxation for their income. However, they derive a part of their income from such non-tax sources as special assessments; fines, forfeits, and escheats; subventions, donations, and assessments; earnings of general departments; and earnings of public service enterprises. In Table 14 we present sources of state revenue in 1944.

TABLE 14. SOURCES OF STATE REVENUE, 1944[a]

Source of Revenue	Amount Received (in millions)	Per Cent of Total Revenue
Income taxes	$ 765.8	17.0
Property taxes	243.2	5.4
Inheritance, estate, and gift taxes	112.2	2.5
Gasoline and motor fuel taxes	691.1	15.3
Sales and use taxes	1,468.9	32.6
Business licenses	286.9	6.4
Motor vehicle licenses	398.2	8.9
All other taxes	125.0	2.8
Non-tax revenue	407.4	9.1
Total revenue	$4,498.7	100.0

[a] Source: National Industrial Conference Board, *The Economic Almanac for 1945–46*, p. 122. Total state revenue, as here reported, does not include federal grants, non-revenue receipts, or unemployment compensation contributions transferred to trust accounts.

State Income Taxation. Because of the great variations in tax laws from state to state and the limitations of space, it will not be possible to discuss in detail the tax provisions of the several states. It is necessary to limit the present discussion to general considera-

tions with respect to the tax systems of the state governments and to the incidence of such taxes as are not already familiar from our previous analysis. Income taxes are used in about three-fourths of the states, and in most cases are not very different, in their general approach, from the federal taxes on income. Income taxes are much less important for state governments than for the federal government. A few states have recently adopted income taxes which provide that their citizens must pay a flat rate of 1 or 2 per cent on their entire incomes, or on incomes above a certain very moderate exemption. Such taxes are, of course, proportional in character and do not correspond to the principle of ability to pay, although they may be productive of large revenue.

General Property and Inheritance Taxes. The general property tax is important and worthy of examination, but it will be treated in connection with the tax systems of local governments, where it assumes even greater importance than in state taxation. Inheritance and gift taxes are used in 47 states, and yielded 2.5 per cent of state tax revenues in 1944. In most states, the inheritance tax is levied upon the several shares of an estate, rather than upon an estate as a whole—which means that it is truly an inheritance tax, and not an estate tax. State inheritance taxes are often progressive in two directions. That is, the rate grows larger the greater the share involved and the more distant the relationship, if any, between the decedent and the heir. The incidence of the state inheritance taxes is similar to that of the federal estate tax.

Sales and Use Taxes. The sales tax has come into prominence, in recent years, as a source of revenue for state governments. The tax has been applied in most states, is based on retail sales, and usually runs from 1 to 3 per cent on the value of the articles sold. According to the data in Table 14, sales taxes and use taxes furnished 32.6 per cent of state tax revenues in 1944. Use taxes are usually intended to prevent people from escaping sales taxes—just as gift taxes are designed to keep them from avoiding inheritance taxes—and have been adopted by most states which use sales taxes. Use taxes are levied as a charge for the privilege of storing, using, or consuming within a state any goods which have been purchased outside the state. A person who lives in a state that has a sales tax, and who purchases goods outside the state to avoid the sales tax, becomes subject to the use tax when he brings the merchandise home. The receipts credited to sales and use taxes in Table 14 apparently in-

clude the revenues received from state excises on liquors, tobacco, gasoline, and other commodities, as well as those from sales and use taxes proper.

The sales tax—and this is true also of the use tax—is decidedly defective from the point of view of our principles of taxation; it is regressive in operation and does not conform to the principle of ability to pay. People with large incomes spend a smaller percentage of their incomes on the retail purchases subject to the tax than do poorer people, so that the tax takes a higher percentage of small than of large incomes. The sales tax is not so well received by the payers as some regressive taxes, for most of the sales tax laws require separate charging of the tax to retail purchasers, in order to promote the shifting of the tax to consumers and to make them conscious of the fact that they are paying it. The sales tax is costly to collect and not at all simple to administer.

Motor Vehicle and Gasoline Taxes and Fees. Most if not all states require the payment of a registration fee annually on all motor vehicles, and many collect additional sums for operators' licenses. Some have even imposed excise taxes on the purchase of new cars. Such excise taxes are paid once and for all, but the owners' and operators' fees are collected repeatedly. While these fees are not taxes in the strict sense of the term, they have about the same effect as taxes on consumption or on the operation of businesses which will shift the taxes to the consumers. The same is true of taxes on gasoline and other motor fuel. All of these taxes, therefore, tend to be regressive in operation. The taxes and fees in connection with the operation of motor vehicles produced over 24 per cent of the total state revenues in 1944.

Other Items. Most states require individuals to have licenses in order to carry on certain businesses and to follow certain professions, and the states derive a considerable income from the fees charged for these licenses. For example, one must obtain a license and pay a fee to sell cigarettes, to operate a tavern, or to work as a barber. These fees become part of the cost of doing business and tend to be passed on to the final consumers through the prices of commodities and services. They produced 6.4 per cent of the total state revenues in 1944. In addition to the items listed in Table 14, payroll taxes in connection with unemployment compensation brought in large amounts of money for the states in 1944. However, these funds must be turned over to reserve accounts for paying unemployment

benefits and should not be counted in general revenues available for ordinary expenditures. The state payroll taxes are similar to those levied by the federal government and tend to have the same incidence.

State Tax Systems as a Whole. In 1944, as in other years, by far the greater part of state revenues was derived from taxes which do not conform to the principle of ability to pay. This means that the revenue systems of the states are highly regressive in operation and that the burden of state taxation falls relatively more heavily upon the poor than upon the rich. On the other hand, the fiscal adequacy of state revenue systems has improved in recent years. State revenues and expenditures have both been increasing, but the revenues have increased faster than the expenditures, and a number of states have accumulated considerable surpluses.

Local Government Revenues

We shall use figures for cities with a population of 25,000 or over in describing the sources of revenue for local governments. We see from Table 15 that these cities in 1943 received 75.5 per cent of their revenues from taxation, and largely from property taxes, which produced 66.3 per cent of total revenues and 87.8 per cent of tax

Table 15. Sources of Revenue of Cities with Population over 25,000, 1943 [a]

Source of Revenue	Amount Received (in millions)	Per Cent of Total Revenue
Property taxes	$1,713.5	66.3
Other taxes	237.5	9.2
Aid from other government units	436.0	16.9
Contributions from public service enterprises	26.4	1.0
Other non-tax revenue	169.7	6.6
Total	$2,583.1	100.0

[a] Source: National Industrial Conference Board, *The Economic Almanac for 1945–46*, p. 135.

revenues. The revenue from property taxes, in turn, was produced largely by the general property tax, which is the only important type of tax which we have not yet discussed. The "other taxes" levied

by city governments include a wide variety of items, among them local income and sales taxes. The non-tax revenue included, besides aid from other governments and contributions from public service enterprises, such things as fines, forfeits, and penalties; interest, rents, and royalties; donations and contributions; unclaimed money; special assessments; and service charges.

The General Property Tax. Since the tax revenues of city governments are derived in large measure from the general property tax, it will be well to analyze this tax carefully. The general property tax is a tax on property considered as a homogeneous whole, and is sometimes called the "uniform rule" of taxation. This means that the rate of the tax is to be uniform throughout the taxing district and for any amount of property. The tax is based upon the valuation or assessment of property in terms of money. These valuations are estimated by assessors at specified times, and the tax is applied at a certain rate, ordinarily upon the total valuation of the property of the taxpayer in question. Boards of Review are often created for the purpose of correcting inequalities and obtaining a uniform basis of assessment.

Defects of the General Property Tax. The general property tax is based upon the assumption that ability to pay is adequately represented by the ownership of "general property." The defects of the tax are numerous. In the first place, it is based on a mistaken notion as to the nature of property. Property is an institution which guarantees to the individual the right to use and control, to receive benefit from the ownership of, to exclude others from the use of, and to pass on to others at the time of death or before, whatever economic goods he may acquire. What is called "property" under this tax is in reality made up of two classes of things—wealth and claims upon wealth. Now when certain items of wealth and claims on these same items are both regarded as general property subject to tax, it is clear that double taxation arises. Thus, the corporation is taxed upon certain items of wealth, such as buildings and machinery, and the stockholder is taxed upon his shares of stock, which are the claim upon these articles of wealth. This is double taxation in the worst sense because it is largely if not entirely unintentional, and because an item of wealth and a claim upon that wealth are both taxed at the full rate charged other items of wealth which are not represented by similar claims. In the second place, it is assumed, at least by inference, that nothing other than "property" represents ability to

pay taxes. This is clearly untrue at present, for many persons have very large incomes derived from personal services, but possess little wealth that is reached by the general property tax.

A third and important defect of the general property tax is that it is grossly inequitable. The assessment is made by assessors who are ordinarily dependent for their positions upon some of the people whose property is to be assessed. They are for the most part untrained and inexperienced, and do their work in a relatively short time. The result is inequitable valuation and taxation. Much intangible property (that is, claims upon wealth) escapes assessment altogether, while real and tangible personal property is assessed in a most discriminatory fashion. As expenditures have increased on the part of the governmental units dependent upon this tax, it has been found necessary to increase the rate at which the tax is applied. This has given to the owners of intangibles an increased incentive to evade assessment, which means a smaller amount of property of this kind assessed and a still higher rate, which in turn stimulates further evasion, and so on. Evasion of the tax is easy on the part of owners of intangibles, because their correct assessment depends so largely upon the cooperation of the taxpayer himself.

Though in theory the tax is based upon proportion (that is, the same rate being intended to apply regardless of the amount of property an individual has), it seems altogether fair to say that the tax has been regressive in its operation. The owners of great wealth are able to consolidate much of their holdings in forms which escape the tax, while it is well known that real and tangible personal property is progressively underassessed. Thus, the rate actually paid upon "general property" tends to be lower, the greater the amount of property possessed by the individual. In addition, it becomes more and more difficult as time goes on to insure the fiscal adequacy of the tax, for it is not easy to adapt the tax to increasing fiscal needs. It is decidedly inelastic.

Classified Property Taxes. In some states and local governmental units attempts are made to avoid the difficulties arising under the general property tax by adopting what are called "classified property taxes." As the name suggests, the various items of wealth and claims upon wealth are divided into classes for purposes of taxation, with a different rate of taxation for each class. The purpose is to obtain a more equitable distribution of the burden of taxation and, of course, to make possible the more efficient administration

of the taxation of property. The tax rate applied in each class is high or low, depending chiefly upon whether the items in the group can easily evade assessment and taxation. The lowest rate is accordingly applied to intangible personal property for the above reason and in order to avoid any serious double taxation. Tangible personal property is less mobile than intangible, but there are nevertheless means of evasion open for such items of wealth. Consequently, a moderate rate is usually applied in this group. Least mobile and least likely to evade taxation is real property, and the highest rate of all is imposed upon wealth of this type.

Improvement of the General Property Tax. Many suggestions might be made for improving the general property tax. The assessors should be appointed rather than elected, and the county should be the unit of assessment, with the whole procedure under state supervision and control. The collection of the tax should be improved, with delay allowances, and the remission or reduction of penalties, eliminated. The interest penalty for delay in payment should be two or three times the current rate on real estate loans, in order to prevent borrowing from the government through non-payment of taxes. No further exemptions from the tax should be granted for the purpose of attracting business enterprises to a community, and a reassessment of "properties" should be made oftener than is at present the case. Constitutional limits on tax rates might well be repealed, and the tax should be used only to supply revenue for the local units of government.[8]

The Incidence of the General Property Tax. It is not feasible to discuss the incidence of this tax as a whole. It must be considered as it falls upon owners of different kinds of wealth. So far as the general property tax is a tax on land, the tendency is strong for the burden to rest finally upon the owner of the land, regardless of whether he pays the tax originally. Land is not a commodity produced at the will of man, but is fixed and non-extensible in amount, for all practical purposes. The rent of land, and consequently its value, are determined by the conditions of demand for and supply of land. There is nothing about a tax on land which will make its user willing to pay a higher rent for it, nor will its supply be affected in any way by such a tax as is ordinarily applied. Therefore the tendency is for the owner of land to bear the burden of any tax placed on it. It

[8] These recommendations are from *Facing the Tax Problem,* New York, Twentieth Century Fund, 1937.

should be remembered that this is the case stated in its bolder terms. Many qualifications and variations of assumptions have been made in the past in presenting the theory of the incidence of the tax on land, but in the majority of the cases which are of practical importance the tendency as stated above is clearly observable.

The incidence of the tax tends to be quite different when it falls on buildings, rather than on land itself. A tax on buildings tends to fall upon the tenant rather than on the owner, unless these two happen to be the same person. Buildings are simply one form of the investment of capital, and if a tax is imposed which temporarily falls upon the owners and makes the return from this investment smaller than that which can be obtained in other lines, the tax tends to be shifted. The process of shifting is a long-run process, and comes about through an exodus of capital from the taxed form of investment, which enables the capital that remains in this line to receive as high a return as it received before the imposition of the tax.

A tax on buildings, then, seems to be merely one case of the taxation of capital. So far as a tax falls upon some lines of investment and not upon others, or upon some more heavily than upon others, there is a tendency for it to be shifted through the process outlined in the preceding paragraph. So far as a tax affects all capital alike, its shifting or non-shifting depends upon whether, in the long run, the tax is sufficiently high to operate as a check upon saving and the accumulation of capital. This possibility has already been discussed in connection with the criticisms of progressive taxation. To the extent to which the general property tax is imposed on articles of wealth which will be used not as capital in further production but merely for personal consumption, the prospect of shifting the tax is practically nil, because such articles do not ordinarily enter into later price transactions.

Conclusion. Since about three-fourths of the total federal revenues are received from taxes which are at least nominally progressive, and since federal revenues are several times as large as those of state and local governments combined, it is possible to say at present that taxation in the United States is on the whole progressive in operation. In other words, the larger part of our total tax revenue is received from taxes which take a larger percentage of large than of small incomes. This is a desirable situation and it should be maintained.

It appears that federal revenues will continue to be several times

as large as those of state and local governments combined for some years to come. Thus, if the tax system as a whole is to be kept on a progressive basis, any reductions in federal taxation which become possible should be accomplished largely through the reduction or elimination of excise and other unprogressive taxes. The changes in excise taxation should be accompanied by commitments, on the part of the industries affected, that the savings which result will be passed on to the consumers in the form of lower prices. On the other hand, exemptions under the personal income tax of the federal government should be kept low so that almost all income receivers will make some contribution, however small, to the direct support of the government, and will be aware that they are making such contributions. This may aid in bringing about a public understanding of the relationship between the performance of functions by the government and the necessity of contributing to the support of the government, and thus help to correct the unwholesome, careless attitude toward public funds which has existed in the past.

It is probably too much to expect that regressive taxes can be entirely abandoned, especially since some of them are rather satisfactory from an administrative point of view because they are certain, convenient, and economical in collection. And the use of these taxes may have to be extended at times. When more revenue is needed during a depression—a time when large profits are only a memory and everyone's income is greatly reduced—it may be necessary to extend the use of excise, sales, and other taxes as a temporary expedient. Again, if there is need to finance an enormously expensive war program, it may be necessary to extend the regressive taxes as well as increase rates and lower exemptions in connection with the progressive taxes. But such extensions of regressive taxes should be clearly recognized as emergency measures, and not accepted as permanent changes in our system of taxation.

Finally, there should be a closer integration between the tax system of the federal government and the systems of state and local governments. Some difficulties are bound to arise when all the various governmental units levy taxes on incomes, inheritances, and other sources of revenue. On the other hand, it would not be desirable to make the state and local governments depend entirely on taxes which the federal government did not care to levy. In particular, state and local governments should not increase the use of regressive taxes as these taxes are reduced or discarded by the

federal government. In view of these considerations, it might be desirable to eliminate the state and local tax systems and leave only that of the federal government. In this way all taxes would be collected by the federal government and the revenue divided among the various governmental units. Competitive taxation of the same sources of revenue by various governmental units would thus be eliminated, and it would be more easily possible to keep the tax system as a whole on a progressive basis, since the federal government would know that its actions would not be offset or canceled by those of state and local governments.

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1. What is the nature of taxation, and how is taxation related to public expenditures?
2. What is the problem of taxation?
3. What is the first test of a sound tax system?
4. If a tax system meets this test, what is the next most important consideration? Why?
5. What are the other requisites of a sound tax system?
6. Why is the principle of ability to pay considered superior to other principles as a basis for distributing the burden of taxation?
7. What is at present the most generally accepted indicator of ability to pay? Why?
8. Does taxation according to ability to pay point to regressive, proportional, or progressive taxation? Explain.
9. Distinguish between direct and indirect taxes.
10. List the principal sources of federal revenue.
11. What are the principal characteristics of the personal income tax as applied by the federal government?
12. Comment on the merits and defects of our federal personal income tax.
13. Is the personal income tax a direct or indirect tax? Why?
14. Describe the federal corporate income tax. Why do some people object to this tax? Explain.
15. Does this tax lead to double taxation? Why?
16. Is double taxation always objectionable? Why?
17. Explain how the capital stock tax and the declared value excess profits tax work in combination.
18. Compare the declared value excess profits tax with the excess profits tax of 1940.
19. How does the federal government tax estates? Explain.
20. State and answer the chief objections which are raised against the federal estate tax.
21. What are excise taxes and who bears their burden? Explain.
22. Are excise taxes desirable in themselves? Why?

23. Comment on the importance and desirability of customs duties in our federal tax system.
24. Make several suggestions for the improvement of the federal tax system.
25. Describe the principal sources of state tax revenue and criticize state tax systems as a whole.
26. What is the sales tax and how is it used? Is it a desirable tax? Explain.
27. What are the principal sources of city revenues?
28. In what respects is the general property tax defective?
29. What steps may be taken to avoid the difficulties which have been experienced with the general property tax?
30. What is the incidence of the general property tax? Explain.
31. How does the combined tax system of federal, state, and local governments measure up to the tests of a sound system of taxation? Explain.

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PROBLEMS OF ECONOMIC INSTABILITY

11. Price Levels

The financial pages of our metropolitan newspapers, in reporting the daily transactions on the New York Stock Exchange, ordinarily list stock market prices for a given day under four headings—"open," "high," "low," and "close." This is evidence that stock prices fluctuate even during the limited trading period of a single day. However, these fluctuations do not conform to a general pattern, and they are largely unpredictable. In this respect, stock prices differ from certain other prices in which the changes, though they may be frequent, exhibit a certain general tendency. Commonest among this type of prices are those whose fluctuations follow a seasonal pattern. For example, throughout the period 1916 to 1929, inclusive, the wholesale price of calves reached a yearly "high" in September, and then fell fairly steadily to a yearly "low" which, in all but two years, occurred in either April or May. From this spring low, it again rose gradually to the September high. Thus the general direction in which the price of calves might be expected to move within the year was predictable with a fair degree of accuracy.

Some prices, instead of fluctuating frequently, are surprisingly rigid. Many products of the iron and steel industry fall into this category. For example, the price of open-hearth steel rails and wrought-iron pipe has remained unchanged for periods exceeding five years. We are thus forced to the conclusion that individual prices may be either highly flexible or highly inflexible, some varying apparently at random and others according to a general pattern.

The Nature and Extent of Price Fluctuations

Index Numbers of General Prices. However, despite these differences in individual price movements, it is possible to speak of a *general price level*. This term refers to the general average of all prices prevailing at any given time—though in discussing the statistical determination of the price level we shall find that the phrase "all prices" is, in practice, subject to certain qualifications.

Price levels are customarily expressed, and changes in price levels are measured, in terms of "index numbers." Index numbers of the general price level are constructed by, first, choosing a *base year*, in which the total of the prices included in the index is given an arbitrary rating of 100. Then, after finding the totals of prices of the same goods for earlier and later years, an index number is given to each of those years which bears the same relationship to 100 as the total prices for each of the years bear to the total for the base year.

Index Number Problems. There are two main problems involved in the construction of an index number. There is, first, the selection of a year to serve as a base year. Since the index numbers for all years are compared with that of the base year, which is always expressed as 100, and since, further, it is customary to think of an index number greater than 100 as reflecting prices above normal, and one less than 100 as indicating prices below normal, it is desirable to choose as a base year one in which prices were neither abnormally high or abnormally low. Many of the current price indexes use 1926 as a base, since that year fell approximately midway between the low point of the 1921–22 depression and the high point of the boom in the late 'twenties; but several indexes in present-day use employ an average of the prices during 1935–39 as a base.

The second main problem in the making of index numbers relates to the items to be included in the calculation. Considered in the abstract, the price level is, as has been said, the average of *all* prices. From a practical standpoint, however, the construction of an index number based on all prices would constitute an almost, if not completely, impossible task. Hence, it becomes necessary to select certain specific prices, the movements of which may be regarded as reflecting with a fair degree of accuracy the movement of prices in general.

Wholesale commodity prices constitute a fairly good basis for a price index, for the reason that accurate wholesale quotations are more readily available than accurate retail prices, and vary less than retail prices. The widely used monthly price index of the United States Bureau of Labor Statistics is based on the wholesale prices of more than eight hundred commodities. An index more nearly representative of *all* prices, however, may be secured by including security prices, wages, retail food prices, rents, transportation charges, and other prices.

Weighted Index Numbers. One further difficulty should be noted at this point. Any index based upon a large number of items is certain to include some commodities that are much more widely used than others included in the calculation. Hence, if index numbers are to indicate accurately the significance of price changes, they must reflect the more extensive use of these particular commodities. A change in the price of eggs, for example, might be expected to have a more direct and widespread effect than an equivalent change in the price of Xmas cards. This difficulty may be overcome by the process known as weighting. This means multiplying the individual prices by the quantity of the product sold annually. The aggregate of these prices in the base year is then given the value of 100, and the index numbers of the other years bear the same relationship to 100 as their aggregate prices bear to those of the base year. An index so computed is called a weighted index.

The construction of price index numbers is shown in Tables 16 and 17.

TABLE 16. CONSTRUCTION OF UNWEIGHTED INDEX NUMBERS

The aggregate prices for 1926, which has been selected as a base year, are assigned a value of 100. The index for 1945 is obtained by dividing the aggregate of prices for that year ($6.16) by the aggregate for the base year ($4.93) and multiplying the result by 100.[1]

Commodities	Price per Unit	
	1926	1945
Wheat (per bu.)	$1.24	$1.75
Butter (per lb.)	.41	.48
Fuel oil (per bbl.)	1.47	1.88
Raw wool (per lb.)	1.16	1.30
Tin (per lb.)	.65	.75
Aggregate prices	$4.93	$6.16
Unweighted index	100	125

[1] It is evident that the same result may be obtained by first multiplying $6.16 by 100, and then dividing by $4.93.

TABLE 17. CONSTRUCTION OF WEIGHTED INDEX NUMBERS

The process here is the same as that in Table 16, except that the aggregate prices are obtained by first multiplying the unit price of the commodity by the quantity sold.[2]

Commodities	Units Sold Annually	1926		1945	
		Unit Price	Total Price	Unit Price	Total Price
Wheat (per bu.). .	40,000	$1.24	$ 49,600	$1.75	$70,000
Butter (per lb.)...	100,000	.41	57,400	.48	48,000
Fuel oil (per bbl.).	25,000	1.47	36,750	1.88	47,000
Raw wool (per lb.)	15,000	1.16	17,400	1.30	19,500
Tin (per lb.)..... ..	40,000	.65	26,000	.75	30,000
Aggregate prices			$187,150		$214,500
Weighted index. .			100		115

Extent of Price Level Fluctuations. An idea of the extent of price level fluctuations may be gathered from Table 18, which gives the index of wholesale commodity prices, prepared by the Bureau of Labor Statistics, for the years 1910 to 1945, inclusive.

Limited Implications of Price Level Changes. It should be clear from our comments on the behavior of individual prices that a change in the general price index does not necessarily indicate a corresponding, much less a proportional, change in *every* price, or, indeed, in every price entering into the calculation of the index number in question. Certain prices are relatively inflexible, and such prices not only show a surprising ability to resist the pressure of general price trends but also operate to reduce the extent of the general price level movement. For example, the wholesale commodity index fell from 104 in 1925 to 73 in 1931, but the price of open-hearth steel rails remained unchanged at $43.00 per long ton. We have noted, also, that certain prices follow a seasonal pattern. In such cases a

[2] It will be noted that identical weights are used for both years. Of course, the relative importance of various commodities may vary from year to year. If so, and if the weights are changed as a consequence, the process of constructing a weighted index number becomes slightly more complicated, since it is then necessary to deal with averages instead of aggregates.

TABLE 18. BUREAU OF LABOR STATISTICS WHOLESALE PRICE INDEX, 1910–45

(Base year—1926)

Year	Index	Year	Index
1910	70	1928	98
1911	65	1929	95
1912	69	1930	86
1913	70	1931	73
1914	68	1932	65
1915	70	1933	66
1916	86	1934	75
1917	118	1935	80
1918	131	1936	81
1919	139	1937	86
1920	154	1938	79
1921	98	1939	77
1922	97	1940	79
1923	101	1941	87
1924	98	1942	99
1925	104	1943	103
1926	100	1944	104
1927	95	1945	106

seasonal increase may be sufficiently great to more than offset a general downward price tendency.

On the other hand, the pressure of a general price movement may be strong enough to destroy the seasonal pattern ordinarily reflected by certain individual prices. For example, we have already noted that, throughout the period 1916 to 1929, the wholesale price of calves rose from an annual "low" in either April or May to an annual "high" in September with remarkable regularity. However, the great depression beginning late in 1929 exerted such pressure as to destroy this pattern completely. The price of calves fell almost without interruption from January, 1930, to November, 1932, with the result that in the three years from 1930 to 1932, inclusive, the annual "high" occurred in either January or February, and the "low" was reached in either November or December.

General Prices and Purchasing Power. The price index is the best indicator we have of the purchasing power of money. Obviously, when the general level of prices is high, a given quantity of money buys a smaller amount of goods than it would buy when

general prices are lower. The index of purchasing power is, indeed, the reciprocal of the index of prices, and is derived from the latter according to the following formula:

$$\frac{\text{Price index of the base year}}{\text{Price index of the given year}} \times 100 = \text{Purchasing power index for given year}$$

Thus in 1941, when the wholesale commodity index was 87, the index of purchasing power was 115.[3]

The distinction between the purchasing power of a given amount of money and the total national purchasing power at any given time should be clearly understood. The curves of production, employment, and wages generally bear a fairly direct relationship to the curve of prices. When prices are high, the quantity of money and credit in circulation, and the velocity at which they circulate, are also high. Consequently, the *total national purchasing power* may be great when the *purchasing power of the dollar* is low. It is only the latter, therefore, that can be said to vary inversely with the general level of prices.

The Equation of Exchange. Over any given period of time, a certain *volume of trade* is carried on—that is, a certain number of exchanges take place, an exchange occurring whenever an article is bought or sold. Many of these exchanges are transacted by means of money. But at the present time credit plays a more important rôle in economic activity than money, so that many of these exchanges are transacted by means of credit. We should remember, then, that both *money* and *credit* may be used to transact exchanges, and that each unit of money or credit may be employed many times in a given period of time. The number of times a unit of money or credit is thus used is termed its *velocity of circulation.* Since money and credit are desired not for themselves, but rather as a means to the acquisition of economic goods, it may be assumed that the total amount of money and credit in existence at any given time will be fully employed in exchanging for the total quantity of goods available.

Hence, it follows that prices at which these goods exchange depend upon the relationship between the quantity of money and credit in circulation, the velocity of their circulation, and the

[3] $\frac{100}{87} \times 100 = 115.$

volume of trade. This relationship may be expressed in a formula, known as the *equation of exchange*, which is as follows:

$$P = \frac{MV + M'V'}{T}$$

in which P represents the price level; M, the quantity of money in circulation; V, the velocity with which M circulates; M', the quantity of credit in circulation; V', the velocity with which M' circulates; and T, the volume of trade. Other factors remaining unchanged, it is clear that the price level varies directly with changes in the quantity of money or credit, or in the velocity with which either circulates, and inversely with changes in the volume of trade.

There is a multitude of conditions, such as climatic changes, wars, population changes, technological progress, widespread industrial unrest, governmental legislation, and so on, which may conceivably exert an indirect effect upon the price level by altering the quantity of money or credit, the volume of trade, or the other factors in the equation. Their influence upon the price level will be felt, however, only because of their effect upon one or more of the factors in the equation, for these factors alone exert a direct influence upon the price level. For example, prices might be expected to rise in the wake of a widespread and disastrous drought, but the direct effect of the drought would be a smaller quantity of goods, and therefore a smaller number of exchanges. T in the equation of exchange would then fall, and this decline would tend to cause a rise in prices. Were it possible to conceive of a widespread drought which had no influence upon the volume of trade, we should have a situation in which the drought would bring no change in the level of prices.

Nature of Price Level Changes. A glance at Table 18 reveals the fact that the general level of prices is subject to frequent fluctuations of considerable extent. Any important change in economic conditions almost inevitably results in at least a temporary lack of equilibrium, and its influence spreads throughout the economy as a whole. This disequilibrium is particularly acute when the change is one which could not be accurately anticipated and prepared for well in advance of its actual occurrence. We have seen that certain individual prices follow definite seasonal patterns with considerable regularity. However, the seasonal peaks and troughs of these several individual prices cannot be counted upon to coincide. Hence, they do not operate to produce a markedly seasonal pattern in the general level

of prices. Moreover, whatever influence these seasonally fluctuating prices might have on the general price level might easily be more than offset by the influence of prices which have no such characteristics. The result is that the general price level follows no particular pattern, but fluctuates in a manner which cannot be predicted accurately for any considerable period in advance of the change.

Some Consequences of Price Level Changes

Price Level Changes and the Business Enterpriser. We emphasize *changes in the price level* rather than the existence of either *high* or *low prices*, for whether prices are high or low is of relatively slight importance. Provided only that prices remain relatively stable, the economy as a whole can and will adjust itself to that level, whether it is high or low. Nor would price changes themselves exert a disturbing influence upon the individual if he were engaged simultaneously in the purchase and sale of goods the prices of which were all moving in the same direction and at the same rate. But in an era in which production is characterized by extreme roundaboutness, or indirectness, this is not likely to be the case. The producer often purchases his agents of production some months or even years in advance of the date on which he sells the finished product. In a period of steadily rising prices his purchases of land, labor, and capital will antedate considerably the sale of his product, and this purchase at a low price level and sale at a high will bring him an unusually large margin of receipts over costs. Conversely, when prices are falling steadily his costs are incurred at a point on the general price curve higher than that at which the product is sold. In this case the result will be a reduction in the normal margin of profit; or, if the decline in general prices is sufficiently speedy or the productive process is spread over a sufficiently long period, it may be that sales will have to be made at a loss.

Prices, Incomes, and Expenditures. Since the price level is merely an average of prices, there will seldom be an exact correlation between the trend of a specific individual price and the movement of prices in general. The average individual spends his income for a wide variety of goods, so that fluctuations in general prices may represent at least a rough approximation of fluctuations in the amount of his necessary expenditures. His income, however, will ordinarily be secured largely or entirely from the sale of a single good, or relatively few goods, and therefore may not fluctuate

directly, and will be still less likely to fluctuate proportionally, with the general price level. Large numbers of people, for example, get their entire income from the sale of their labor power, payment being made in the form of a wage or salary. Thus their income depends solely upon the movement of the price of labor. The general level of prices may reflect with fair accuracy the fluctuations in their cost of living, but it is improbable that the curves representing the fluctuations in both general prices and the wages of labor will coincide. Any failure to do so will, of course, result in a change in the standard of living which the wage earner or salaried worker is able to maintain. Should the general price curve fall more rapidly than the price of labor, he will experience an *increase* in terms of real income. But should general prices rise more rapidly than wages, the ability to buy commodities and services, and therefore the worker's real income, will decline.

Price Levels and the Business Cycle. We have said that general price changes would not affect the individual directly provided he were engaged in the simultaneous purchase and sale of goods, the prices of which were all moving in the same direction and at the same rate. But a situation of this kind seldom, if ever, exists. Hence, few if any members of society avoid the direct effects of price level changes. When the results of price movements are experienced at one time by an entire economic group, such as producers or wage earners, the national economy as a whole is profoundly affected. The consideration of price level changes as both a cause and a result of economic developments of national or international significance will be undertaken in the following chapter, which deals with business cycles. For the present, we restrict our inquiry to the direct effect of such fluctuations upon individuals or specific economic groups.

Price Levels and Wage Earners. Producers ordinarily gain during periods of rising prices, and lose through declines in the price level. Wage earners and salaried workers are affected in a contrary manner. We are thinking of salaried workers as those who are paid on an annual or monthly basis, and of wage earners as those paid by the hour, day, or week. Members of both groups suffer a reduction in real income when the price level rises more rapidly than the price of labor, and they enjoy an increase when general prices fall more rapidly than wages or salaries. We may go further and observe that there is a general tendency for changes in the price of

labor to lag behind changes in the price level, whether the latter is rising or falling. Changes in the price level cannot be accurately predicted, and hence wages and salaries are altered as the result of, rather than in anticipation of, general price changes. Salary commitments are made over a longer period than wages, and are therefore less flexible than wage rates. Consequently, though individuals in both of these groups gain when prices are falling and lose when prices are rising, the effect upon the salaried worker is proportionately greater in each case, since it takes longer to make adjustments in salaries than in wages.

Our observations about the gains or losses that result from price level changes, and affect wage earners and salaried workers, are based upon the relationship between their money incomes and the cost of living. These observations assume, therefore, that the persons under consideration are receiving income continuously—that is, that they are steadily employed. But the fact is that a period of falling prices is disadvantageous to the business enterpriser, and that production (and consequently employment) is generally curtailed during such a period. Therefore, our conclusions must be somewhat modified. It is true that the wage earner or salaried worker gains in periods of falling prices *provided he remains employed.* However, in such times unemployment may be so extensive that wage earners and salaried workers, as a group, will experience a reduction in their *aggregate real income*. On the other hand, though those who are continuously employed suffer a reduction in real income when prices are rising, the aggregate of real wages or salaries paid out may show an increase during these periods. This is possible because rising prices are so advantageous to enterprisers that business men tend to increase both production and employment when prices are on the upgrade.

Price Levels and Fixed Incomes. The individual wage earner or salaried worker is affected by price level changes because the price of labor, as compared with general prices, is relatively sluggish. It follows that those persons whose money incomes are completely inflexible will be affected to an even greater degree. This category includes those who live on the income from bonds, annuities, pensions, and the like. In all such cases the amount of money income is definitely fixed, and fluctuations in the cost of living are in no part offset by compensatory changes in money income. The result is that this group reaps full benefit from price declines (unless something

interferes with their getting the payments agreed upon), but must bear the full burden of price increases.

Price Levels and Debtor-Creditor Relationships. Obligations incurred by debtors are also fixed in terms of money. When the debtor borrows a given sum of money he is, in effect, securing possession of a quantity of purchasing power. His future obligation to the creditor, however, is expressed in terms of the given number of dollars received, plus an additional sum representing interest. If the general level of prices is higher when the loan is repaid than when it was made, the specified number of dollars involved in the transaction will have lost a part of their ability to command goods. The debtor thus gains and the creditor loses, for a smaller amount of *purchasing power* is repaid than was borrowed. But if general prices are lower at the time of repayment, the situation is reversed, and the debtor loses while the creditor gains. Of course, the decline in the price level may make it impossible for the debtor to pay his obligations, in which event the creditor also loses.

Farmers often find it necessary to borrow at crop-planting time, and do so with the intention of paying off their loans after the harvest. A decline in the general price level, accompanied by a drop in the price of the products raised, would make it very difficult for these farmers to meet their obligations. Let us suppose, by way of illustration, that a wheat grower finds himself in a position to borrow $500 at 5 per cent interest. With this sum he can purchase fertilizer which he estimates will increase the yield on his land by 650 bushels. Wheat is selling at 90 cents a bushel. Under these circumstances, it would seem advantageous to borrow the money. However, by the time the crop is harvested the general price level has declined and the price of wheat has fallen to, let us say, 75 cents a bushel. It is clear that the value of the additional yield secured through the application of the fertilizer is insufficient to repay the loan.

Our contention that a period of falling prices is advantageous to the creditor is subject to certain qualifications. It is true that a fall in the price level will bring the creditor, when the debtor's obligation matures, a larger volume of purchasing power than that originally advanced. But this is true, of course, only if repayment is actually made. Since, however, a period of falling prices means reduction in gains, and frequently definite losses to business enterprisers, a creditor may find that the fall in the price level has brought bankruptcy to his debtor and made the collection of the debt impossible. Rising

prices, on the other hand, though they mean the return of a smaller amount of purchasing power than was borrowed, also lessen the possibility of default on the part of debtors.

Proposals for Stabilizing the Price Level

Desirability of Price Stability. Among the theories that have been advanced in explanation of the phenomenon known as the business cycle are those which suggest that the causes of cyclical fluctuations in business lie almost exclusively in changes in the price level. So far as the stabilization of general prices would result in general economic stability, which would in turn tend to minimize the frequency and severity of cyclical fluctuations, such stabilization is unquestionably desirable. However, an adequate discussion of the business cycle involves the consideration of factors other than prices, and this discussion is reserved for the following chapter. But, as we have seen, a lack of general price stability has adverse effects upon significant groups, quite apart from its relation to the larger problem of the business cycle. In the interests of wage earners and salaried workers, business enterprisers, creditors, debtors, and others who face the ever-present danger of loss through unpredictable price level changes, it is highly desirable to find, if possible, some means of minimizing these fluctuations or of neutralizing their unpleasant consequences.

Our discussion of the equation of exchange indicated the important rôle which the quantity of money and credit in circulation plays in the determination of the general price level. It is natural, therefore, that proposals designed to stabilize prices should concern themselves largely with attempts at *monetary stabilization*—that is, with various devices by means of which the quantity of money and credit in circulation might be regulated, or managed, primarily by governmental action. A glance at the equation of exchange shows that complete price stability cannot be achieved merely by keeping the quantity of money and credit unchanged, but requires a continuous adjustment in the quantity of M and M', so as to offset the influence of changes in the volume of trade (T in the equation) upon the price level.

It is doubtful whether *complete* and *permanent* price level stability is desirable. Our economy has, for a considerable period, been characterized by a steady and continuous increase in technological efficiency. One of the principal and inevitable consequences of

technological progress has been a reduction in the costs of production. If permanent price level stability were to be maintained in the face of steadily declining costs, the result would be an increase in profits to an extent which might eventually prove as harmful to a balanced economy as present price fluctuations. Hence, it might be desirable to "manage" the monetary system, so that the price level would decline gradually and thus keep pace with decreasing costs. This would substitute for the present price changes—which are sudden, frequently severe, and generally unpredictable—a slow but steady trend, progressing in a definitely predictable direction, and at a rate that could probably be predicted with a considerable degree of accuracy. Proposals for achieving price stability might be employed, then, either to maintain an absolute stability or to bring price movements into accord with the long-run curve of declining production costs.

The "Compensated Dollar." A proposal known variously as the "compensated dollar," "stabilized dollar," and "commodity dollar" has Professor Irving Fisher as its leading advocate. Our present dollar is defined as a specific amount of gold of a given degree of fineness. We have seen that a rise in prices means a fall in the purchasing power, or value, of the dollar. A decline in the value of the dollar represents, in effect, a fall in the value of gold in relation to other commodities for which the dollar is exchanged. The compensated dollar plan proposes to stabilize prices by adjusting the *gold content* of the dollar in accordance with fluctuations in the purchasing power of gold. Of course, frequent variations in the gold content of the dollar would be impracticable, so long as gold was in actual circulation. Consequently, it is proposed to withdraw gold coin from circulation, and to substitute circulating media consisting of gold certificates. What would actually be subject to alteration would then be the amount of gold bullion which a gold certificate would command at the mint.

We may illustrate the manner in which the plan would presumably work. Let us assume an increase in the general price index from 100 to 110. This rise would indicate that sellers are, on the average, demanding for their goods 10 per cent more money—that is, 10 per cent more gold—than formerly. If, therefore, the gold content of the dollar were to be increased by 10 per cent, these sellers would get the amount of gold they demand, and without increasing the number of dollars (that is, the price) that buyers are required

to pay. The index of prices, if expressed in terms of gold, would remain 10 per cent above the previous level, but if expressed in terms of numbers of dollars it would decline to the original level. We may assume that a fall in prices indicates a willingness on the part of sellers to accept a smaller amount of gold in exchange for their goods. Under the compensated dollar plan, a decrease in the gold content of the dollar would enable sellers to secure the same number of dollars as was previously paid them, and, at the same time, would not require buyers to part with gold in excess of the amount demanded by the sellers.

In terms of the equation of exchange, this plan would undertake to achieve stability by varying the quantity of money in circulation. This is true, since any increase in the gold content of the dollar would reduce the dollar value of the government's gold reserves, and therefore the quantity of gold certificates that could be circulated. A contraction of the currency would follow, and this would result in decreasing prices. A decrease in the gold content of the dollar, on the other hand, would increase the quantity of gold certificates that would be circulated, and there would follow an expansion of currency with a simultaneous increase in the price level.

Since the compensated dollar plan relies solely upon variations in the quantity of money in circulation to achieve price stability, the extent to which it might be expected to succeed would seem to depend upon the directness of the relationship between the quantity of money and the quantity of credit. We are aware of the present importance of credit. We know, however, that credit is based upon and limited by existing stocks of gold reserves. If it were certain that alteration in the quantity of money would produce an immediate, direct, and proportional change in the quantity of credit, we should be warranted in saying that price stability could be maintained through the control of money. But it seems reasonably certain that, in the short run at least, the volume of credit may vary considerably without corresponding changes taking place in the volume of money. Hence, it would appear that the compensated dollar could achieve price stability only if it were supplemented by control over the quantity of credit in circulation.

It is evident that the plan depends upon the use of a price index number to indicate the nature and extent of changes to be made in the gold content of the dollar. We have seen that certain subjective elements of judgment enter into the construction of an index num-

ber—there is, for example, the question of which prices are to be included and which excluded. Since the inclusion of all prices is a practical impossibility, an index number is at best merely a more or less successful approach to an accurate measure of price level fluctuations. The success of the compensated dollar plan would inevitably be limited by inaccuracies in the index number upon which it was based, and therefore the plan would of necessity fall short of perfection in its actual operation.

Stability Through Credit Control. Until comparatively recent years, it was confidently believed by many persons that the Federal Reserve Banks and the Board of Governors of the System could halt the overexpansion of credit, and even do something by way of bringing about a contraction of credit, if such "interference" should be deemed necessary. The nature of the machinery of control over credit was described in Chapter 7.

In that chapter, we noted that the Board of Governors seemed to have control powers which would enable it to prevent the overexpansion of credit *in any ordinary situation.* But the situation it faced at the close of World War II was anything but ordinary. The financing of that war, as has already been explained, flooded the country with so much money and credit that the Board was powerless to prevent the serious inflation which threatened if our wartime controls over *individual* prices (which were imposed shortly after our entrance into the war) were allowed to expire with the expiration of the O.P.A. law authorizing them, as many of our business men recommended. We shall examine this agency of price control briefly in the concluding section of the present chapter.

Price Control vs. Price Freedom. Whatever devices may be used to control credit, and wherever the power to create credit may reside, the fact remains that it would be an almost superhuman task to determine the precise moment at which credit control should be exercised. For this reason some persons feel that disturbances created by the free functioning of an automatic price system are preferable to possible consequences of attempted control of the price level by political agencies. Past experience has shown that such attempts have sometimes aggravated existing difficulties, instead of alleviating them. On the other hand, to abandon all hope of exercising conscious control over economic phenomena is to adopt an unnecessarily fatalistic attitude. We cannot undertake here to compare the relative merits of economic planning and economic

automaticity, but it is clear that this broad issue is involved in any comprehensive proposal to stabilize the price level by interfering with its free and "natural" movement.

Wartime and Post-War Price Control

The serious inflation which accompanied World War I enriched some persons while impoverishing others, and increased the cost of that war by about 150 per cent. It was doubtless the recollection of this "by-product" of World War I that led the United States government, even before the attack upon Pearl Harbor, to adopt measures designed to prevent a disastrous rise in prices from taking place during World War II.

The Dangers of Too Much Money. Our study of price fluctuations has shown that a substantial increase in the quantity of circulating media without a corresponding increase in the quantity of goods (the velocity of turnover of money and credit being neglected in the interests of simplification) inevitably raises the price level. The situation faced in World War II was a very great increase in the quantity of money and credit, and a serious decrease (instead of increase) in the quantity of goods available for civilian purchase. Total production in the United States increased enormously during the war, but the current output of goods consisted largely of things which either were not wanted or could not be obtained by civilians, Under these circumstances, the buying public, with an unusually large number of dollars at its disposal, tended to bid excessively high prices for the limited quantity of goods offered for sale. The natural result, unless interfered with, would have been a rapid rise in the general price level.

Relieving the Public of Excess Money. During World War II, the government took measures to relieve the consumers of the excess money which could do them no good and might do much harm. Taxation was one of these measures; and in each of the wartime years many billions of dollars in taxes were collected from Americans. The sale of bonds, which also took from people money which (with a shortage of consumers' goods) they could not spend to advantage, brought in additional billions of dollars, year by year. Further billions were set aside (that is to say, not used in buying goods) through private savings of other kinds. But even after the public had surrendered portions of its money income in the ways we have mentioned, there remained in its possession larger amounts

than were sufficient to buy the available civilian goods at normal prices; and this excess, which is usually called the "inflationary gap," tended to cause trouble by raising the price level. The need for price control, in the form of "price ceilings," was recognized in the early days of the war, and led to the passage of the Emergency Price Control Act, which became law in January, 1942.

The Nature of Price Ceilings. Stated briefly, this law provided that the prices of virtually all commodities and a great many services be "frozen" as of March, 1942. Foods of most kinds, clothing, fuel, furniture and furnishings, hardware and agricultural supplies, rents, and many other types of goods (both material and non-material) were included in the thousands of articles covered by price ceilings. In the case of "cost of living" items, which comprised important articles in the budgets of families in the low- and middle-income groups, the maximum prices had to be publicly posted by the seller for the protection of the buyer. Additional powers of control over individual prices were granted under the Anti-Inflation Act of 1942 and a number of Executive Orders issued by the President.

We cannot undertake here to deal with the countless problems which arose in connection with attempting to administer price-ceiling control on so extensive a scale. There were difficulties, in some cases, of determining what the maximum prices should be. There were instances of unintentional violation of the law. There were deliberate violations by selling in the black market at higher than ceiling prices, and by reducing the quality of a given good while maintaining the old maximum price of a better article. There was, in 1942, the necessity of freezing wages, for it became clear that it was grossly unfair to stabilize the selling price of a good while the cost of production was rising by reason of wage increases. There were instances in which it was necessary to grant price increases or wage increases in given industries if they were to continue to function; and other instances in which sellers were required to hold to the maximum prices, but were granted governmental subsidies to enable them to stay in business.

The Success of Wartime Price Control. It is quite impossible, of course, to isolate the several elements which constituted our wartime price-control mechanism and to determine how well each element served its purpose. However, the clear fact is that the combined efforts of all of the controls that were employed brought surprisingly satisfactory results. The wholesale commodity price index

number (1926 = 100) of the United States Bureau of Labor Statistics rose from 77 in 1939 to 106 in 1945, as against a World War I rise from 68 in 1914 to 154 in 1920—or a price rise of 29 points in World War II and 86 in World War I. Even more impressive was the showing made after 1942, the year that price control was adopted seriously; for the wholesale commodity index rose only 7 points in this period, when production, and hence the volume of purchasing power in the country, were making new high records.

An examination of the cost-of-living index (1935–39 = 100) shows a greater advance in prices. This index rose from 116 in May, 1942, when price control went into effect, to 130 in December, 1945, and it is probable (as has been charged by union leaders and others) that an accurate comparison of both quality and price would indicate a still larger increase. Nevertheless, on the evidence that is available, it may be said that the operation of price controls kept prices fairly well in hand during the years of actual combat in World War II.

Post-War Price Controls. As was to be expected, the surrender of Germany and Japan brought demands from a number of industrialists and several strong business associations that price controls be abolished as of June 30, 1946, the date of expiration of the law under which the controls were authorized. It was urged that, with the war successfully concluded, it was high time to remove all restraints to production and to the right to set prices at whatever figures the traffic would bear. The typical argument of these opponents of price control was the one widely publicized by the National Association of Manufacturers.[4] The gist of this argument, presented in the N.A.M.'s own words as it appeared in hundreds of full-page newspaper advertisements, was as follows:

"ISN'T THIS THE ANSWER? NAM has said: Remove price controls on manufactured goods and production will step up *fast*. In a survey of a representative cross section of NAM membership, 97% find price controls are hampering production. Remove these controls and goods will pour into the market. Within a reasonable time, prices will adjust themselves naturally—as they always do when production goes up—in line with the real worth of things. This is the way you can get the goods you want at prices you can afford to pay."[5]

[4] At an admitted cost for advertising of approximately $400,000, and a later reputed cost of $700,000.

[5] *The New York Times*, April 19, 1946.

This question was answered with an emphatic "No" by a very substantial number of business men, most professional economists who expressed an opinion, and an estimated 600,000 private individuals who wrote or telegraphed their Senators to support effective price control, after the House of Representatives had passed, early in 1946, a bill extending the life of price-control legislation for nine months but with amendments which rendered it practically powerless.

Described in economic terms, the situation in which the country found itself in the first half of 1946 was as follows:

1. There was an unprecedented shortage of goods of many kinds, goods which people had long wanted to buy, and which (in certain demonstrable cases) were being withheld from the market by sellers in anticipation of the removal of price controls on June 30, 1946.
2. There was also an unprecedented volume of liquid assets in the hands of individuals and business concerns, totaling some 226 billion dollars.[6]
3. In addition to these liquid assets already in existence, account had to be taken of the new money income that always accompanies new production, which in 1946 was being created at the rate of some 150 billion dollars a year.

The advocates of continued price control insisted that this was an economic setup which, in the absence of *direct* price controls such as those administered through the O.P.A., would almost necessarily give way to disastrous inflation; that inflation not only would work hardship on millions of families in the low- and middle-class income groups, but would lead to the prompt conversion of war bonds into cash, which would in turn be spent as promptly as possible to avoid further losses through later price spiraling; that union workers, seeing their real incomes whittled down by rising prices, would stage strike after strike for more pay; that the abnormally high profits accruing to business men in periods of rising prices would result in undue expansion of plant (which the Federal Reserve Board could not prevent, in view of the nature of the country's war financing); and that this feverish prosperity would surely give way to the greatest depression in our history, because it would

[6] *Federal Reserve Bulletin,* February, 1946, p. 123.

follow the country's biggest business boom—the outcome, in turn, of the unrestrained spending of more money and credit than this country had ever before amassed.

Answering the specific question posed by the N.A.M. and its colleagues, the champions of the extension of price control urged that the O.P.A. should be continued, with its power to keep price ceilings on individual commodities and services until such controls could safely be removed—that is to say, until production had sufficiently caught up with demand, in the case of a given good, so that the ceiling could be removed without the price skyrocketing. They held that if, as the N.A.M. wished, price controls were removed *first,* the prices of goods would almost certainly leap forward so promptly and so far that production would have little chance of overtaking them. They argued that the announcement that price controls would be retained as long as they were necessary would lead hoarders of goods to abandon their "sellers' strike" and throw their stocks of withheld goods upon the market. They expressed the belief, in general, that practically all ceilings could be safely removed within a year, but that the O.P.A. should not be obligated to remove the ceilings in the cases of those goods which, if released from control, were fairly certain to experience extensive rises in price.

The Desirability of Post-War Price Control. Freedom from economic restrictions, except such restraints as may be necessary to safeguard the public welfare, is one of the cardinal principles of a capitalistic system. This is particularly true of restrictions placed upon the price mechanism—a fundamental characteristic of capitalism, which, it will be remembered, is often called "the price system." Hence, it is our view that there is no place in our capitalistic economic society for price controls of the O.P.A. type in *normal* times. But it is evident that the first six months of 1946 were so clearly abnormal that it would have been extremely hazardous to abandon price ceilings and look to the "free market"—which had not yet been restored—to provide fair, safe prices.

American experience following World War I indicates that inflation is more likely to come *after* than *during* a war; and it indicates, further, that inflation is likely to end in depression, as it did in 1921–22. In the interests of avoiding such dire consequences, the price controls required in a modern war must, we believe, almost inevitably be continued for a time after the cessation of hostilities. However, we believe that these controls should be *selective* rather

than *general,* being applied only to such economic goods as are abnormally scarce; that prompt and sympathetic consideration should be given to "hardship" appeals, though without a guaranty of prices that would cover costs plus a "reasonable profit" (which would render the program unworkable); and that the control agency should make a point of removing the ceiling price from each good just as soon as it seemed clear that public injury would not result.

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1. What is meant by the price level?
2. What is a price index number?
3. What problems of selection are involved in the construction of an index number?
4. Why are many price indexes based upon wholesale commodity prices?
5. How do weighted and unweighted index numbers differ?
6. Construct (a) an unweighted and (b) a weighted index number.
7. Does a change in the price level mean a corresponding change in all prices? Explain.
8. What is the relationship between the index of prices and the index of purchasing power?
9. If the index of prices is 114, what is the index of purchasing power?
10. Distinguish between total national purchasing power and the purchasing power of the dollar.
11. State the equation of exchange, explaining each of the terms contained therein.
12. In what way might frequent and numerous industrial strikes affect the price level?
13. Do general price level fluctuations possess any particular characteristics? Explain.
14. How is the business enterpriser affected by price level changes? Explain.
15. Will the average individual's income, or his expenditures, fluctuate more nearly in accordance with the price level? Why?
16. What is the distinction between a wage earner and a salaried worker?
17. How are wage earners and salaried workers affected by price level changes? Explain fully.
18. How are creditors and debtors affected by price level changes? Explain fully.
19. Why might complete and permanent price level stability be undesirable?
20. Describe and criticize the "compensated dollar" plan.
21. What powers to influence the price level are provided in the Federal Reserve System?

22. What is there about a wartime economy which tends to lead to inflation?
23. What measures were taken by the federal government, in World War II, to "siphon off" large portions of the excessively large quantity of circulating media which was in the possession of the people of the United States?
24. Explain the nature of, and the need for, price ceilings in wartime.
25. Discuss the degree of success with which wartime price controls functioned in the United States during World War II.
26. What are the chief arguments *for* and *against* the continuance of price controls in a post-war period? Examine these arguments in the light of your knowledge of the nature of price fluctuations and their consequences.

References for Further Reading

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12. Business Cycles

In the preceding chapter we discussed the construction of an index number of the general price level, based upon information regarding individual prices. In an essentially similar manner, it is possible to construct an index number of the volume of production, making use of production figures for particular commodities. When the statistician speaks of an index of production, he usually has in mind an index number that includes only agriculture, mining, and manufacture—that is, the creation of *form* utility. When production is thought of as embracing all phases of activities that increase utility, an index of production is commonly termed *an index of the volume of trade*. For example, the Federal Reserve Bank of New York prepares an index of trade which includes statistics on manufacture, construction, car loadings, imports, exports, wholesale and retail trade, electric power production, bank debits, security sales and issues, and so on. In such an index, attention is given to activities that represent the creation of time, place, possession, and service utilities as well as form utility.

The Nature of Business Fluctuations

Seasonal and Random Fluctuations. Since any such index is representative merely of an average, there is no reason to suppose that there will be exact correspondence between the index of production in general and the index of production in any given industry. However, the general index will be affected somewhat by a change in any of the items upon which it is based. Just as there are seasonal price patterns for certain commodities, so also there are seasonal production patterns in certain industries. Seasonal peaks and troughs will not necessarily coincide as between industries, and will tend to offset one another to some extent. However, there is a degree of correspondence in individual seasonal production trends that is

sufficiently pronounced to impart a generally distinguishable seasonal pattern to the movement of production as a whole.

Production in various fields is also subject to the influence of such unpredictable events as wars, floods, droughts, strikes, and the like. The fluctuations resulting from occurrences of these kinds are irregular and are called, by the statistician, random fluctuations. Certain of these fortuitous developments may affect a sufficiently large number of fields to produce a random fluctuation in the index of trade as a whole.

The Trend of Production. Despite the frequency with which the volume of production varies in particular fields, it is usually possible to determine whether a given type of production is, on the whole, expanding or contracting. Automobile or radio production may vary from month to month, and even from year to year, but both industries have clearly been growing rapidly, if not uninterruptedly, since their inception. The manufacture of carriages and player pianos, on the other hand, has been steadily declining in recent years. The life of most industries is characterized by a gradual rise from a small beginning to a productive peak which may be maintained with little change for an indeterminate period, to be followed eventually by a gradual decline in the face of the introduction of new commodities.

The relatively steady, long-run movements that characterize this process are called the *trend*. Within any economic system will be found both expanding and contracting types of economic activity. Of course, one may offset the other, but it is more likely that there will be greater expansion than contraction, or vice versa, with the result that a definite long-run trend may be observable in the index of production or trade as a whole. Despite periodic setbacks, the economic system of the United States was unquestionably expanding—that is, exhibiting an upward trend—up to 1929. While our difficulties since that date have been of unusually long duration, and production did not again reach and pass the trend level until stimulated by the demands of defense and war, there is no reason to suppose that the previous upward trend will not be resumed in the post-war period. Indeed, many persons confidently expect that we shall profit by our wartime experience in production to the extent of turning out goods in quantities that will dwarf our former peacetime output. Of course, population growth or decline ordinarily plays an important part in determining the trend of production, and will doubtless influence it in the future.

The Statistical Determination of Cyclical Fluctuations. It is possible for the statistician to "adjust" his data. He may, for example, eliminate the seasonal influence, the effect of random fluctuations, or other sources of irregular fluctuations. The determination of the trend exhibited by his data becomes possible when the effects of these other factors that might influence the situation have been eliminated. This trend can be carried back in time, making it possible to contrast the actual movements with the movements which would have taken place had there been no interference with the general tendency toward expansion or contraction. It is possible, likewise, to project this trend line a certain distance into the future. However, the extension of the trend curve into the past or future is always subject to inaccuracies.

Our primary concern, in the present chapter, is not with seasonal or random fluctuations, or with the trend of economic activity, but rather with cyclical fluctuations. The latter are less regular than the seasonal, but more regular than the random fluctuations. Moreover, they may exert a simultaneous influence upon various forms of eco-

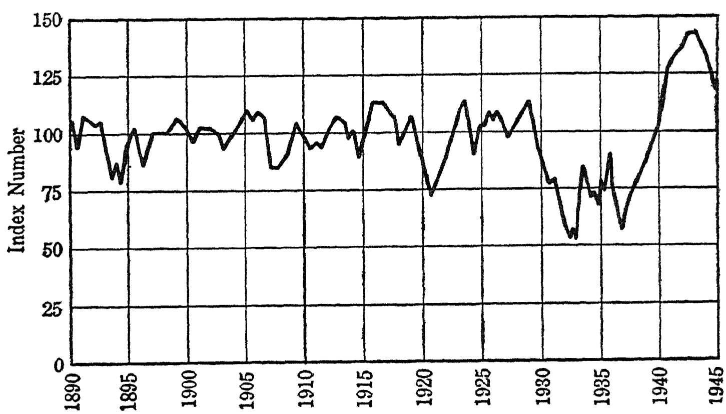

FIG. 2. Cyclical Fluctuations in Business Activity, 1890–1945.

nomic activity. What we have said thus far should serve to suggest methods of measuring the extent of cyclical fluctuations. In one method of measurement, the first step is the computation of the trend. The second is the elimination of seasonal and random elements from the data. Variations between the trend line, on the one hand, and the curve of the data corrected for seasonal and random

elements, on the other, represent cyclical fluctuations. In the construction of Fig. 2, a trend line was computed and regarded as representing "normal" conditions. The curve of business activity, corrected for seasonal and random variations, was then plotted above and below 100, indicating the extent to which it departed from the trend line.[1]

Fig. 2 shows that fluctuations in business activity have been frequent, and on many occasions have varied extensively from the "normal." The most pronounced and most prolonged departure from the normal, as is indicated clearly in the figure, occurred in the period from late 1929 to 1945.

Cyclical Regularity. By the term "business cycle," the economist means the period between successive peaks of business activity, or (since a cycle, strictly speaking, has no beginning) the period between successive troughs. Attempts have sometimes been made to generalize as to the length of the cycle. However, it is becoming increasingly apparent that such generalizations attribute to cyclical fluctuations a greater degree of regularity than they in fact possess. So long as cyclical variations are to be distinguished from the purely seasonal, the cycle must be thought of as extending over a period of time longer than a single year (and ordinarily for two years or more), but little more than this can safely be said of the duration of business cycles.

Periods in the Cycle. Our hesitancy to generalize as to the length of the cycle should not be regarded as an implication that business cycles are completely lacking in common characteristics. For example, every major cycle may be divided (somewhat arbitrarily, it is true) into four periods. These periods are, in the order of their occurrence, *prosperity, liquidation* (also called the period of *crisis* or *recession*), *depression,* and *recovery*. Each of these periods, moreover, appears to possess some similar characteristics in all major cycles. The period of prosperity is generally characterized by a large volume of production, which is selling at high prices. The creation of this large output requires a large volume of employment, which is paid for at relatively high money wage rates. The heavy demand for credit to finance the extensive business activity leads to large bank deposits, high interest rates, and low bank reserves.

Prosperity is followed by the period of liquidation. (We shall at-

[1] Adapted from a chart prepared for the Cleveland Trust Company, Cleveland, Ohio, by Colonel Leonard P. Ayres.

tempt presently to explain the causes of the transition from one phase of the cycle to another. At this point, we aim merely to describe briefly the nature of the individual phases.) The period of liquidation is marked by declining prices, lessened production, increasing unemployment, and lower wages. On the financial side, bank deposits and interest rates are falling and bank reserves increasing. During the depression phase, prices, production, wages, employment, bank deposits, and interest rates are at a minimum. But all begin to rise in the period of recovery which follows. The cycle is completed when the recovery movement develops into a new period of prosperity, which will generally attain, in an expanding economy, a level of production higher than that reached by the preceding peak of prosperity. It should be added that what we have been describing is an "ideal," "normal," or "average" cycle, so the description is not applicable to *every* business cycle.

Probable Causes of the Business Cycle

The Problem of Explaining the Cycle. The frequency of occurrence and the general similarity of business cycles constitute the basis for believing that it may be possible to find a general explanation of the manner in which each peak of prosperity leads ultimately to crisis, and a new peak eventually begins to rise from the trough of depression. However, it would be quite a difficult matter to secure general acceptance of any specific explanation. Business cycles cannot be studied in the laboratory, but must be observed in their particular historical contexts. Almost invariably there are certain random factors that are peculiar to any given historical period. Hence, it is easier to find an explanation for an individual business cycle in specific than in general terms.

The problem is further complicated by the common tendency to seek monistic interpretations and explanations of developments in any field of inquiry. As we have seen, the business cycle affects prices, production, finance, and, in short, most aspects of business activity. It would seem to follow that developments in any of these fields might in part explain the development of the cycle. Moreover, as will be stressed later, the psychological factor, as distinct from the economic, may play an important part in cyclical movements, and the political factor is assuming increasing importance. For these reasons, any monistic explanation must be suspect. Pluralistic explanations, on the other hand, run the risk of being so gen-

eral in nature as to be either meaningless in terms of definite causal relationships, or incapable of accurate verification, or both.

Factors Influencing the Cycle. Business cycle theories have been developed, offering sunspots, weather cycles, the exploitation of wage earners, oversaving, underconsumption, discount rates, and optimistic and pessimistic error as explanations of these fluctuations in business activity. It is not possible for us to examine critically all of these many theories. And since any monistic theory would seem to constitute an oversimplification, it is probably best to restrict ourselves to certain factors which seem to play a part in any satisfactory explanation. These include industrial, financial, and psychological conditions.

By industrial conditions, we mean levels of production, commodity prices, wages, profits, the volume of employment, and the degree of industrial unrest. Cyclical fluctuations are generally measured in terms of these conditions. The most important of the lot is probably the level of production, since the other conditions may be expected to vary primarily as a result of earlier changes in the volume of production. By financial conditions, we mean primarily the level of bank reserves and bank deposits, and the nature of the prevailing rate of interest. By psychological factors, we mean the degree of optimism or pessimism which exists among those who play an active rôle in the guidance and direction of production. It is unquestionably true that business cycles are not purely mechanistic in character. Business activity may expand in the face of structural weaknesses in the economic system, or decline to a low level in the face of external conditions that are apparently favorable for expansion. These conditions are the consequence of an undue optimism or pessimism which may characterize the attitude of the enterpriser and the capitalist.

Psychological Explanations. In a sense, it would be difficult to exaggerate the importance of the psychological element. Recognition of this fact has led to attempts to explain the business cycle almost solely in terms of alternating periods of overoptimism and overpessimism. The former, it is said, leads to a too rapid expansion of production, which continues until doubt arises as to the possibility of continued expansion. This doubt spreads, a wave of pessimism grips the business community, a crisis occurs, liquidation and extreme contraction follow and continue until the almost total depletion of existing stocks gives rise to a new era of optimism.

But do not such theories overlook the fact that psychological attitudes are unlikely to change without some reference to external conditions? It would seem that the psychology of the business enterpriser must have some basis in past or present economic conditions. It is more reasonable to suppose that changes in such objective conditions create psychological reactions, than that the psychological state is the prime mover. The principal importance of the psychological factor, therefore, appears to lie in the part it plays in accentuating, or prolonging, the periods of the cycle, and not in providing an explanation of the original cause of the transition from one stage of the cycle to another.

Much the same position must be taken with regard to the influence of such "external" conditions as wars, natural catastrophes, and the like. Their power to precipitate or prolong, to accentuate or diminish, a particular stage in any given business cycle is undeniable. Such random factors, however, can scarcely be regarded as furnishing a clue to the general cause of so regularly recurrent a phenomenon as the business cycle.

A Pluralistic Explanation. The crux of the problem is to determine the factor or factors which produce the transition from one period to another. This does not mean a mere enumeration of the consequences of such a change, once it has begun. Nor is it the same thing as listing the wide variety of developments which might affect the duration and extent of a movement in a given direction, once that movement is begun. To speak of the beginning of a cycle, however, is a contradiction in terms, for (as we have already suggested) a cycle, like a circle, obviously has neither beginning nor end, but is a continuous process. Therefore, we must break into the cycle at an arbitrary point, and seek to determine why the conditions then existing failed to continue indefinitely, and instead were transformed in such a way as to bring about a passage from one period of the cycle to the next. To attempt to work backwards is impossible, for in so doing we should inevitably be forced to make our way through an infinite number of earlier stages. We must start, therefore, at some arbitrarily selected point and work forward.

Admitting, then, that our selection of a particular point is arbitrary, let us break into a "normal" business cycle during the period of prosperity. We have already noted briefly the characteristics of this period. Prices are high and rising still higher. Our discussion of price levels in the preceding chapter showed that a period of rising

prices is advantageous to the business enterpriser. Hence, enterprisers expand their output as rapidly as possible during this period, in order to reap the full benefits of the rising price level. This expansion brings an abundance of employment and relatively high money wages. Increased production also increases the demand for credit, so that bank credits eventually expand to the limit, and interest rates are abnormally high. Because of the increase in the general price level and the large margin of profit enjoyed by producers, the prices of corporate securities show a steady increase. An increase in stock prices, if continued over a considerable period of time, leads to an increase in speculation and a corresponding increase in the demand for credit with which to finance this speculative activity.

Throughout this period, the desire of enterprisers to expand their productive capacity leads to an excess of investment over savings. Also, the increase in productive capacity takes place at a rate more rapid than the increase in consumption. This situation results from the previously noted tendency for wages and salaries to lag behind price movements. However, the optimism that prevails may be sufficiently strong to support continued advances, so long as resources and credit for further expansion are available. But once the available resources and credit are exhausted, the situation becomes extremely precarious. It is highly probable that, in certain lines, production has so far outstripped demand that large stocks have been accumulated, with the result that output must be curtailed, at least temporarily. Such curtailment stops or reduces the purchase of raw materials, decreases employment, and consequently reduces purchasing power.

The reduction in purchasing power lessens the ability of consumption to keep pace with production in general. Hence, contraction spreads to other fields, and each successive contraction still further reduces purchasing power and forces additional curtailment in production. In the face of such developments, bankers naturally become apprehensive about their extremely low reserves and begin to call in loans. Producers, having borrowed to buy new plant, the output of which faces a steadily contracting market, find difficulty in meeting their obligations. Loans to speculators are also called by the banks. Cash to meet obligations can frequently be secured only by the sale of securities. Such forced security sales depress the security market, already adversely influenced by unfavorable business conditions. Security prices may be forced down to such a point that their sale will not bring in an amount sufficient to meet loans

that have been made on them. In this way, too, the forced sale of industrial commodities to meet the demands of banks generates a precipitous and disastrous decline in commodity prices. Pessimism becomes widespread, banks refuse credit even on sound security, and business men decline to expand production even in certain fields where expansion might be feasible. The period of prosperity is now definitely at an end. The falling level of prices discourages production, and lessened production leads to further unemployment and consequent declines in purchasing power.

Eventually, forced liquidation comes to an end, and prices, having fallen precipitately, begin to stabilize at a low level. We have now passed through the period of crisis and entered the period of depression. Here the volume of production is small, and unemployment is widespread. Conditions in general, however, show a relative stability. While pessimism continues, it represents primarily a fear to expand, rather than a fear of further contraction.

Despite the scarcity of purchasing power during a depression, an irreducible minimum of consumption, determined by the size of the population, is bound to take place. This minimum will, in many fields, exceed the depression level of production, and the result is a gradual reduction in existing stocks of goods. Eventually, production in these lines must be increased if only to satisfy depression demands. Increased production results in increased employment, and hence in increased purchasing power. The rate of consumption is therefore raised, and further expansion of production follows as a consequence. As demand increases, prices begin to rise once more, creating a further condition favorable to business expansion. When these conditions become sufficiently strong to offset the pessimism that has prevailed throughout the depression, we are well into the period of recovery, which will eventually culminate in a new era of prosperity. But the latter will ultimately lead to a crisis, for reasons similar to those which caused the previous collapse.

We have here an explanation which is consistent with the fact that the cycle has neither beginning nor end. The theory avoids oversimplification by considering the influence of industrial, financial, and psychological factors. Avoiding reliance upon random factors, this explanation is not inconsistent with the degree of regularity exhibited by the cycle. Finally, by placing the source of each period of the cycle in the preceding period, it gives to the cycle a self-perpetuating character which explains the regularity of its recurrence.

The Stabilization of Business Activity

Desirability of Stabilization. Every period of depression means bankruptcies, unemployment, idle resources, want, and suffering. The desirability of introducing stability into economic activity, for the purpose of eliminating, or mitigating, the catastrophic consequences of recurrent depressions, would seem scarcely open to question. However, reliance upon pure automaticity, as opposed to conscious control, would necessitate the rejection of deliberate attempts at stabilization. It might be argued that the depression represents a painful but necessary period of cleansing for the economic system. Inefficient producers are driven out of business, and only the efficient survive. The expansion of production which ultimately follows the contraction of depression finds the productive agents reallocated, to a certain extent, in the interests of greater efficiency and of maximum ability to satisfy changed and changing demands.

Viewed in this sense, the business cycle insures the survival of the fittest, and, because it constitutes a threat to producers, it serves as an added incentive to maximum efficiency in production and the greatest possible effort to direct production so as to accord with the prevailing public desires. Finally, the believer in unadulterated automaticity may resort to the generalization that the cures attempted by any deliberate interference in the unhampered functioning of the economic mechanism will inevitably be worse than the disease which they seek to overcome. The implications inherent in such an attitude were noted in the preceding chapter. For the same reasons, we are again forced to reject this line of argument and to hold that any proposals which offer the possibility of achieving a greater degree of stability in our economic life merit our serious consideration.

The Significance of Proposals for Stabilization. We have given some indication of the complexity of the business cycle. We were forced to reject monistic interpretations of the phenomenon. Consequently, there is no reason to believe that proposals dealing with isolated factors can eliminate the cyclical nature of economic activity. Considered separately, the most that can be expected of the proposals discussed below is a diminution in the frequency and severity of continuing fluctuations. Any considerable degree of stability would probably require the simultaneous adoption of a number of devices. It should be clearly realized that no single

measure, and possibly no combination of measures, is likely to provide a *complete* cure.

Cyclical Stability Through Price Stability. The effect of rising price levels, in stimulating too rapid an expansion of production during periods of recovery and prosperity, has been mentioned. Conversely, in the period of liquidation, falling prices force unduly rapid contraction. The way in which purchasing power may lag immediately preceding a crisis, because of the failure of wages and salaries to advance as rapidly as prices, has also been observed. It becomes apparent, then, that a plan of price stabilization might be used in an attempt to influence cyclical fluctuations. Hence, either of the proposals considered in the preceding chapter for stabilizing the general level of prices might be applicable also to the present problem.

There is no need to describe and analyze these proposals again. It would appear, however, that the most promising proposal for price stabilization in what may be called "normal times" is the intelligent use of the existing control over bank credit now entrusted to the Board of Governors of the Federal Reserve System. The potentialities of increased stability from this source are great. However, their successful application would require not only a high order of intelligence, but also the ability to resist public pressure. The achievement of stability would require the periodic use of measures for checking expansion. It is almost inevitable that both enterprisers and labor would vigorously resent and oppose governmental action that would be likely to limit the expansion of production and employment. If, however, control is to be effective, it must be applied before expansion has run its normal course and collapsed under its own weight. If the control of credit could be made to prevent undue expansion, the necessity for the liquidation and contraction which lead to depression would never arise.

Stability Through Public Works. A second approach to the problem of stabilization centers around the maintenance of a reserve of public works projects. We have seen that, once the peak of prosperity has been reached, the initial steps in the direction of contraction lead to the creation of conditions which force further contraction. Specifically, contraction in even a single important field diminishes the available supply of purchasing power, and this decreases sales generally, and necessitates a reduction in production in a variety of fields. It is argued that if the government were to

keep in reserve a large-scale program of needed public works, and begin to put the program into operation as soon as contraction in private business took place, the decline in purchasing power would be prevented and the spiral of contraction halted.

It should be noted that we are dealing here with a plan which is not to go into effect until the peak of prosperity has been reached and passed. There is abundant reason to suppose that any such peak represents an abnormally high level of activity, which probably ought not to be maintained by artificial means, and certainly could not be permanently maintained except through huge governmental expenditures which would eventually threaten the credit standing of the government. The chief value of expenditures for public works in connection with the business cycle would seem to lie in the possibility that they might prevent a panic, and promote instead an orderly and gradual contraction. To attempt to prevent any recession whatsoever from the peak of prosperity would appear to be unwise. Hence, the proposal under consideration seems more likely to work out successfully in limiting the severity of cyclical fluctuations than in decreasing the frequency with which such fluctuations occur. It should be clear that the peak of prosperity would not reach such dizzy heights if, in "good times," the government collected revenue in excess of its current needs, thus reducing somewhat the purchasing power that would otherwise be available for private spending; nor would the trough of depression reach such profound depths if, in "bad times," these surplus funds were expended on public works.

Stability Through Unemployment Insurance. Somewhat similar to the plan just described, because of its dependence on maintaining purchasing power, is the proposal to secure stability through the agency of unemployment insurance. The benefits paid to the unemployed from insurance funds would presumably take the place of the wages workers would be losing because of unemployment attributable to lessened production. Here, again, is an attempt merely to prevent the reaction from a business boom from becoming too serious; and the usefulness of this device would lie chiefly in its contribution to orderly contraction as an alternative to the panic of liquidation.

If we are to make expenditures for public works or pay insurance benefits to the unemployed, we must use care in selecting a sound method of raising the required funds. An unemployment program

that aims to prevent the spread of a business contraction which has already entered its initial stages should not be financed by levying new taxes. For additional taxes would curtail private spending, and would merely change the direction of economic activity, and not increase its volume. Likewise, it would be futile to pay unemployment benefits from the receipts of current taxes. This financing should be done, rather, by public borrowing, on the theory that the situation is one of emergency, and for the reason that this borrowing will tend to increase the total volume of circulating media, and thus of purchasing power.

There is no good reason why unemployment premiums should not be collected in normal times, and the funds thus accumulated used to reduce the public debt, so that governmental credit and therefore borrowing power would be in excellent shape when emergency loans were necessary to provide funds for the payment of unemployment insurance benefits. Presumably, the financing of public works (advocated in the preceding section) would be done in essentially the same way—the public debt being reduced steadily with payments made from the surplus funds collected year by year, so that the government would be in a favorable borrowing position when it was necessary to build extensive public works in order to combat depression.

Stability Through Direct Action. It will be seen that the plans discussed thus far suggest an approach to the problem of stability. They propose that we aid in promoting stability in production through such devices as the manipulation of money and credit, a public works program, and contributions to purchasing power in the form of unemployment benefits. The *direct* approach would involve the establishment of production quotas, and the direct control of output in the interests of stability. Under present conditions, we have no choice in this country as between the direct and the indirect approach. The former would mean the violation of the institutions of freedom of enterprise, freedom of competition, and private property, which most Americans prize highly. The direct approach could be used only by the exercise of a much larger degree of governmental control over business than now exists in the United States.

The utilization of the direct approach must await, therefore, our decision as a people to embark upon a planned economy under the guidance of the state, should such a decision ever be made. Whether

such a transition is desirable is a debatable question. It is highly probable that a fair degree of stability could be attained in a planned economy. But whether stabilization would take place at a level so low as to more than offset the advantages derived through the elimination of frequent fluctuations is an open question. Moreover, we have in the past succeeded in maintaining a long-run *rising trend* of production, in spite of periodic fluctuations. It is possible that a rigidly controlled economy would tend to become static, substituting long-run stability for our present long-run expansion.

Among the characteristics of our present economic order are the following: A considerable degree of freedom of action for privately owned enterprises, with regard to price and production policies; rapid technological progress, resulting in frequent changes in the methods of production, and the continual development of new industries and disappearance of others; practically complete freedom of choice for consumers, with consequent frequent changes in the nature of demands; at least relatively free competition for the agents of production; and various legislative restrictions upon certain activities that are adjudged to be in restraint of competition. So long as these characteristics survive, it seems highly improbable that we shall succeed in eliminating the business cycle as a periodically recurrent phenomenon. But there is no need to accept the idea that we can do nothing either to mitigate the intensity and consequences of periodic contractions, or to check the unduly rapid expansion which seems to be the root of the difficulty. To adopt a defeatist attitude such as this would indicate an unwarranted lack of faith in human ability.

Reform, Relief, and Recovery. Though an ounce of prevention is said to be worth a pound of cure, societies often manifest more interest in solving problems after they have arisen than in preventing their appearance in the first place. This is certainly true of the specific problem of the business cycle. The business community in general worries but little, during the upward swing of the cycle, about the possibility that expansion may eventually get out of hand. Most of our concern over business cycles is reserved for the period of depression.

The consequence is that we tend to confuse three separate and distinct classes of proposals. There are, first, the measures of reform. These are attempts to increase the degree of stability in economic

activity, and include certain plans that we have already discussed. Second are proposals for relief. These represent efforts to lessen the suffering and want that mark every period of economic stagnation. Third are devices aimed at bringing about recovery. Included in this class are all measures that are designed to increase economic activity. The measures directed toward bringing back recovery are temporary measures that have immediate objectives, and differ from the reform measures, which are permanent in nature and are aimed at long-run objectives. The situation is further complicated by the fact that there may be a considerable amount of overlapping among these three types of activities.

In the period which immediately preceded the crisis of 1929, little concern was manifested in fluctuations in economic activity. The era was characterized by an almost unprecedented optimism and a widespread belief that business depressions were phenomena of merely historical interest. But with the stock market crash of that year came disillusion, and our actions in the depression years provided a striking example of simultaneous attempts at reform, relief, and recovery. This was particularly true of the period following 1933, for the federal administration in power prior to that date had based its policy on the assumption that the economic structure was fundamentally sound, and that little, if anything, in the way of reform was needed.

Governmental Attempts at Stability Since 1929. It is well to note that, though political agencies in this country seldom hold the power to control economic activity directly, nevertheless it is to these agencies that we must turn for the initiation of any extensive measures that may be indicated for achieving either economic reform or business recovery. When faced with disequilibrium throughout the entire economic system, we cannot rely on the efforts of individual enterprisers to restore normal conditions. Action on an industry-wide basis, through trade associations or labor organizations, is only slightly less futile, (1) because of the high degree of interdependence between industries, and (2) because "cooperation" between business men is so likely to take the form of price-fixing through restriction of production.

Governmental attempts to remedy the situation that existed between 1930 and early 1933 consisted in large part of expressions of confidence in the fundamental soundness of our institutions and appeals to employers to maintain employment and wages. Regard-

less of whether our enterprisers saw the social desirability of following this advice, the situation was such that they could not afford to do so in the absence of a governmental program directed toward insuring a general maintenance of purchasing power.

The Roosevelt Stabilization Program. With the inauguration of the Roosevelt administration in 1933 came the beginning of the most vigorous program of reform, relief, and recovery with which the United States has ever undertaken to combat a business depression. We may outline this program briefly at this point, though many of its specific features are described elsewhere in this volume.

As we have said, it is often hard to distinguish clearly between relief and recovery measures. However, we may consider as predominantly "relief" measures certain agencies that were established (1) to provide loans to distressed debtors and (2) to promote public works. Among the first was the Reconstruction Finance Corporation, established during the Hoover administration. Its task was to make loans (1) to banks that were fundamentally sound but in temporary difficulties; (2) to the several states for use in relieving unemployment; and (3) to corporations on the verge of bankruptcy. The Farm Loan Corporation was established to provide credit to farmers; and relief to home owners was extended through the Home Owners' Loan Corporation. These three agencies unquestionably aided in mitigating the suffering which inevitably accompanies a period of depression. They served the further desirable purpose of retarding the rate of liquidation.

The public works program inaugurated by the Roosevelt administration was unprecedented in its scope. Several billions of dollars were appropriated in each of a number of years, for carrying on this program of public construction. The desirability of planning public works in advance soon became apparent, for the program was slow in getting under way because adequate plans had not been prepared. Further delay was caused by a dispute over the relative merits of long-range planning and the building of works of lasting usefulness, as contrasted with engaging in a host of unrelated projects in which wages for labor would be the predominant cost. From the point of view of economy, the extensive adoption of the second of these policies was probably unfortunate.

While loans and expenditures for public works may halt a downward trend, action of a sterner character is required to promote positive revival. Hence, the Roosevelt administration experimented

with a variety of measures dealing with monetary matters. The general program has been termed "controlled inflation." The President was granted power to reduce the gold content of the dollar, to issue large additional quantities of "greenbacks," and to increase the quantity of silver in the monetary system. The object of these devices was, apparently, to raise the general level of prices, and this in turn was expected to lead to increased productive activity, for reasons which were discussed in the preceding chapter. However, this stimulus to price rise was offset, to some extent, by difficulties experienced in effecting an expansion in bank credit, over which the government had no direct control. These difficulties led to renewed demands, in certain quarters, that the government be given control over all agencies for the creation of credit. Whether this would or would not be desirable, it is certain that price control can be made genuinely effective only through the regulation of both money and credit, and not of money alone.

A further attempt to aid recovery took the form of trying to increase the incomes, and thereby the purchasing power, of wage earners and farmers. The National Industrial Recovery Act sought to increase wages and decrease unemployment by reducing the length of the working week. The cooperation of employers was secured by granting them, through the codes established under the Act, the right to impose limitations upon price competition, and in some cases upon the volume of production, within a given industry. The Agricultural Adjustment Act sought to increase farm incomes by raising the prices of agricultural products. This was to be done by reducing crop acreage. Both of these Acts are open to criticism on the ground that they embodied a general policy of curtailed production. As a long-run objective, such curtailment has no economic justification. As an emergency measure, it seems a highly dubious method of getting back to either a high level of employment or a large volume of industrial production. Further, both measures revealed the difficulties of governmental efforts to influence economic activity, when the government has little or no power to control prices.

It is probable that the N.I.R.A. prevented wages from falling to as low a point as they would have reached had no such device been adopted. However, far from insuring against the possibility of prices increasing at a more rapid rate than wages, the Act practically invited such a wage lag. Hence, it contributed little to the real income

of industrial workers. The restrictions on production embodied in many of the codes likewise offset the increase in employment which might otherwise have resulted from the undeniable reduction in hours. The increases in the level of industrial commodity prices also offset, to a considerable degree, the benefits of the increased money incomes that accrued to farmers through the operation of the A.A.A.

The Supreme Court ruled that both of these Acts were unconstitutional. However, in the field of agriculture, the Agricultural Adjustment Act of 1938 provided an essentially similar farm measure. This Act is dealt with in our discussion of agriculture.[2] The N.I.R.A. has not been replaced, but the Fair Labor Standards Act of 1938 provided for increases in the money incomes of industrial workers whose wages were strikingly low.

In the field of "reform," the Roosevelt administration adopted the following measures: (1) The passage of legislation increasing the powers of the Federal Reserve System; (2) the establishment of the Securities Exchange Commission; (3) the attempt to improve industrial relations as outlined in the Wagner Act; (4) the inauguration of a comprehensive program of social insurance. What will be the effects of these measures upon business stability in the future is a matter of speculation. It would appear that the possibilities of checking an undue expansion of business before it has attained dangerous proportions have been increased. It would also seem probable that the widespread payment of unemployment benefits will act as a brake upon the downward trend of purchasing power in periods of contraction. There is, however, no reason to believe that the problem of economic instability has been solved to any appreciable extent. It must be borne in mind that many governmental measures adopted in the post-1929 depression were designed to meet emergency conditions of that particular period of "hard times," and might not be applicable to another, and different, depression.

The Theory of Full Employment

We must not close the present chapter without discussing briefly a program for combating depression that has won many adherents among economists and others, more particularly since 1936 when the late Lord Keynes published his now famous work, *The General*

[2] Chap. 20.

Theory of Employment, Interest, and Money.[3] In this book, Keynes presented the results of a study of unemployment which had been engaging his attention for some years.

The Keynesian Approach to Unemployment. The "Keynesian approach" to the problem of business depression, and the unemployment which inevitably accompanies it, may be described in a greatly simplified form, as follows: Production of the commodities and services which are turned out in a given period involves the expenditure of sums of money in the form of costs of production. To the persons to whom the payments are made, this *expenditure* constitutes *income.* Furthermore, the amount of expenditure and the amount of income are necessarily equal, for what is expenditure to the payers is income to the receivers. If all of this income is spent promptly, it will provide the funds for financing an equal amount of production in the *following* period—and this is true regardless of whether it is spent for consumers' or producers' goods. If more than this amount is spent, having been added to from other sources, production in the ensuing period will be stimulated. But if less than the total income is expended, through hoarding or some other type of withholding of purchasing power, production will be depressed, it will reach a smaller total than in the previous period, and unemployment will result.

"Offsets" to Savings. We saw, earlier in the chapter, that depression follows close upon the heels of cumulative prosperity, which means that a high level of employment and income gives way to a low level of both employment and income. The Keynesians maintain that the business boom, which brings a rise in national income, brings increases also in most individual and family incomes, and that, under these conditions, "billions of dollars . . . are saved each year because people have incomes in excess of their consumption needs, because of a desire for personal security, because of power considerations or greed, because of automatic institutional arrangements, and for a thousand other reasons. It is irrelevant whether the process is deliberate or unconscious, whether prudence and thrift are involved or greed and lust, whether or not there is pain and abstinence. The desire to accumulate is a social *fact,* to be taken as such. And whatever might or might not be true of a Robinson Crusoe economy, it is clear that in modern societies

[3] John Maynard Keynes, *The General Theory of Employment, Interest, and Money,* New York, Harcourt, Brace & Company, Inc., 1936.

individuals save regardless of the magnitude of investment outlets. Even if no new securities were floated, attempts to save would continue; and if old securities were not available, it would still be possible to accumulate non-interest-bearing assets in cash." [4] It must be remembered, of course, that in addition to individual and family savings are the savings of business enterprisers. It is the withholding of *all kinds of savings* from the expenditure stream that leads to a reduction in production and an increase in unemployment, unless these savings are offset in some way. The normal offset to savings is investment by the savers or their agents; but in the absence of adequate private investment other offsets must be found.

Granted that large sums out of the total income that was produced in the preceding period are withheld from current expenditure, it would seem to follow that the deficit must be made up if the volume of forthcoming production is not to decline. It is the failure to make up this deficit that turns prosperity into depression, and full employment into unemployment. To insure the continuance of full employment, and the avoidance of depression when total expenditure for consumption and investment is inadequate, other funds must be found which will offset the amounts saved, and thus bring the total amount expended up to its former high level. Only in this way can production, and consequently employment, be kept from declining. Though there are a number of possible offsets to these savings,[5] the one that bulks largest in the program of the Keynesians is governmental spending.

The Government's Rôle in Providing Full Employment. Up to this point, we have purposely omitted any mention of governmental spending, though it is obvious that expenditures by government often play a very important part in stimulating or maintaining production and employment, and it is in governmental spending (national, state, and local) that the Keynesians find the remedy for oversaving. We have seen that income, once received, may or may not be returned promptly to the expenditure stream. It is proposed that, whenever there is a deficit in expenditure such as we have described, the government shall undertake (through its taxing and borrowing power) to supply the funds that are required to bring

[4] Paul A. Samuelson, in *Postwar Economic Problems* (Seymour E. Harris, ed.), New York, McGraw-Hill Book Company, Inc., 1943, pp. 36, 37.
[5] *Ibid.*, pp. 40–46.

the total expenditure up to the amount needed to provide full employment.

This does not mean that the government itself would go into business by becoming a producer of goods, but rather that it would finance the purchase of desirable goods on a sufficiently large scale to take up the slack which would otherwise result from the failure of a considerable portion of the *income* to be converted promptly into *expenditure*. "Private business can and will do the job of production," says Professor Hansen, a prominent advocate of governmental spending for the maintenance of employment. "It is the responsibility of government to do its part to insure a sustained demand. We know from past experience that private enterprise has done this for limited periods only. It has not been able to insure a continuous and sustained demand. The ever-increasing gigantic powers of production of the modern industrial system, far exceeding those of any earlier experience in history, mean that an enormous output has to be reached before full employment is approached. Private industry and government together must act to maintain and increase output and income sufficiently to provide substantially full employment." [6]

The Meaning of Full Employment. Some opponents of governmental spending to provide work have debated at considerable length the meaning of "full" employment, and argued that even in periods of peak production there has always been and will continue to be some unemployment. We have been reminded that there are unemployables, who either are incapable of doing work that the world wants done or for temperamental or other reasons simply find it impossible to hold jobs; and that among our able workers some are always out of work by reason of seasonal or technological unemployment while others are in process of moving from old to new jobs, and are for the moment unemployed.

It is only fair to say that the Keynesians do not pretend to prescribe for unemployment of these kinds, which may on the average affect a million or more workers annually, but for the prolonged and much more deadly economic ailment of cyclical unemployment. One writer, in what seems to us a sound interpretation of the term, defines full employment as "a condition under which every person who is able and willing to work can find enough employment in the

[6] Alvin H. Hansen, in *ibid.*, p. 14.

course of a year to earn not less than enough to maintain his habitual standard of living."[7] The problem, then, becomes one of preventing the recurrence of business depressions, with their burden of involuntary idleness on the part of persons of unquestioned ability who are obviously anxious to find work. To avoid fruitless controversy over the impossibility of achieving *full* employment, when the term is interpreted literally and rigidly, some writers have adopted the practice of using the expressions "substantially full employment"[8] and "reasonably full employment."[9]

What Might the Government Buy? Critics of this kind of program frequently cite the governmental expenditures of the post-1929 depression as evidence, first, that such spending is very wasteful, and, second, that it does not put a speedy end to a depression.

To the first of these contentions, the Keynesians answer that our governmental spending in the 1930's, so far as it was wasteful, was so largely because it was unplanned. Extensive, hastily executed projects for which detailed plans have not been drawn up in advance are pretty certain to be inefficiently carried out. The Keynesians hold that well-considered planning, which has reached the blueprint stage well in advance of the emergency, would give us an excellent chance to get "our money's worth" in return for whatever expenditure would have to be made in order to insure full employment; and that the expenditure, moreover, could always be made for goods of which society stands in genuine need and of which we are unlikely ever to have an excess. Roads (including underpasses at railway crossings), more adequate educational institutions of all grades, enlarged hospital buildings with the most modern facilities, new housing for millions of families with small incomes—these are but a few of the "public" projects upon which national, state, and local governments might conceivably spend funds which, if not spent in these ways to avoid depression, would have to be expended in large measure for purely "relief" purposes.

It has been suggested, moreover, that there are many other types of expenditure which would pay large social dividends, over and above the prevention of depression (if, indeed, it were prevented) or its reduction to a more manageable size. Sir William Beveridge, in

[7] E. A. Goldenweiser, in *Jobs, Production, and Living Standards,* Washington, Board of Governors of the Federal Reserve System, 1945, p. 4.

[8] Alvin H. Hansen, quoted in the present chapter.

[9] *Fortune,* Supplement, December, 1942, p. 7.

proposing a program of this kind for England, lists not only public spending of the kinds we have mentioned above, but also investment in a socialized sector of industry, including transport and power and coal or steel; the creation of a National Investment Board to provide loans and tax rebates to private business as a means of stabilizing private investment; the encouragement of low prices for essential consumers' goods, if necessary, by a system of subsidies; and an increase in private spending to be brought about by increased national income and broadened social security provisions. Some of these suggestions, it will be noted, are at present more appropriate for England than the United States, since they assume a larger degree of public ownership than prevails in this country.

As for the criticism that our public spending did not put to rout the greatest depression we have ever experienced, the usual answer is that the program which we adopted was a halting, half-hearted one; that we did not at any time spend sums large enough to provide full employment, but continually lived in hope that the governmental "pump-priming" would soon enable private enterprise to go ahead without public assistance; and that public spending for full employment, once begun, must be carried on relentlessly until the battle is won. Indeed, the Keynesians see no reason why the government should not indefinitely finance full employment, since they regard such financing as less wasteful than paying relief benefits to millions of unemployed and having thousands of businesses closed down because the demand has not been sustained. Moreover, since it is axiomatic that human wants are indefinitely expansible, they hold that there will always be worth-while undertakings upon which to spend public funds in such quantity as to provide the expenditure required to maintain an economy which would offer employment to all who were able and willing to work.

Paying the Bill for Full Employment. The ordinarily troublesome question of how to pay the bill is met by the Keynesians in this way: The cost of providing full employment, like the cost of every governmental project, will have to be paid from public revenues. This means, in the long run, that the people must pay for these desirable goods through taxation, though at times the cost might have to be met through borrowing—that is to say, through "deficit financing."

To those who accept the Keynesian doctrine, the problem of securing sufficient funds holds no terrors. What must be done above

all else is to keep production going! If the output of the country is maintained at a high level, the national income will necessarily be large and there will be no difficulty in securing from taxation whatever revenue is required to finance the program of full employment. As Professor Hansen puts it:

> The notion that we cannot finance our production is quite without foundation. Every cent expended, private and public, becomes income for members of our society. Costs and income are just opposites of the same shield. We can afford as high a standard of living as we are able to produce. We cannot afford to waste our resources of men and material. We cannot afford to use them inefficiently. But we cannot afford idleness. The idleness of the decade of the thirties was responsible for the loss of 200 billion dollars of income. . . . There is not—there cannot be—any financing problem that is not manageable under a full-employment income. From an income so vast [as we produced in war years] we can raise large tax revenues—large enough to service any level of debt likely to be reached and to cover all other government outlays—and still retain for private expenditures much more than we had left in former years. . . . But it is not necessary or desirable under all circumstances to finance all public expenditures from taxes. Whether taxes should equal, fall short of, or exceed expenditures must be decided according to economic conditions.[10]

The Current Attitude Toward Full Employment. There can be little doubt that people in general favor full production—a volume of output which would keep our factories, mills, stores, and other places of business humming. Probably most Americans would prefer to have this full production—and consequent full employment—brought about through free enterprise rather than through governmental "interference." But some at least have come to agree with Sir William Beveridge in his belief that no power less than the state can assure adequate total spending at all times. It was doubtless the acceptance of this view, coupled with a recognition of the necessity for outlawing unemployment, that prompted the Editors of *Fortune* in 1942 to publish this declaration: "We propose that the government should underwrite permanent prosperity: that it be established government policy, whether Republican or Democratic, to maintain reasonably full employment in the United States." With this statement went the argument that private industry must have "every chance to operate at capacity and to invest as much of the nation's savings as it can absorb." But the conclusion was unequivocal:

[10] *Postwar Economic Problems*, p. 15.

"When involuntary unemployment threatens to be either chronic or widespread, it is not to be borne. We believe the government should set a minimum, and a minimum reasonably close to our full capacity, below which employment should never be permitted to fall." [11]

Professional economists are divided in their appraisal of the desirability of attempting to avoid depression and unemployment through governmental spending. The average American citizen, we may safely assume, knows little or nothing about the Keynesian theory; and the action taken by Congress in 1946 on a "full employment" proposal indicates that the idea has not yet won great favor in our national legislative halls. It is true that Congress passed the Murray-Patman Act, which purported to deal with the problem; but what began as a "full employment" measure wound up, as we recorded in Chapter 5, as an "employment-production" Act which gives little promise of providing the country with the detailed, long-range program which the Keynesians regard as essential to their program. Certain persons who were keenly interested in the passage of effective legislation of this type accepted the Murray-Patman Act as "better than nothing" and "a move in the right direction"; but it is hard to believe that this Act will be the instrumentality through which either the truth or the falsity of the Keynesian theory of employment will find practical demonstration.

Criticisms of Public Spending to Provide Full Employment. Critics of programs of this kind direct their attack along several lines. First of all, they question the necessity of governmental spending on a large scale, arguing that if government will adopt a "hands-off" policy, business depressions will doubtless come and go much as they did prior to the post-1929 depression—which, they charge, was prolonged by "interference" from the Hoover and Roosevelt administrations. They frequently attack the so-called theory of economic maturity—the notion that the country has so fully exploited its economic possibilities that attractive opportunities for investment are too limited to use up our unconsumed current income—though this theory is not an essential part of the Keynesian doctrine.[12] They hold that if the government will only restrict its economic activities to the encouragement of free enterprise, by passing just tax laws and other legislation favorable to business, private investment will be so

[11] *Fortune*, Supplement, December, 1942, p. 7.
[12] *Ibid.*, p. 8.

greatly stimulated that governmental spending to insure full employment will be unnecessary. They argue that there is no guaranty that governmental spending would solve the problem of unemployment, that it might easily lead to governmental participation in control, to a considerable degree of government ownership, or even to a planned economy closely resembling socialism, and they point out that in a society of this type we would sadly miss certain "freedoms" which we now accept as a matter of course.

These are important criticisms, to each of which the Keynesians naturally have what they consider to be adequate answers. We cannot undertake to examine them in detail, though in most instances they have been touched upon elsewhere in this book.[13] The plain truth is that no one knows definitely and with certainty what the outcome of a thoroughgoing program of governmental spending would be, and the chances are that we shall never know unless and until we try it out. An economic society which is beset by recurrent depressions and unemployment "takes a chance" no matter what its course of action or inaction may be. Undoubtedly there is a possibility that harm might result from the adoption of the policy of spending which we have been examining. We incline to the view that a freely operating capitalistic system, with a minimum of governmental control and regulation, is likely to furnish a higher average level of employment, production, and income than would result from the adoption of any governmental full employment policy which did not include some possibility of eventually leading to collectivism, and perhaps even to political and economic dictatorship. On the other hand, there may be grave danger in not taking specific measures to conquer the business depression. Such well-known economists as Frank H. Knight, Paul H. Douglas, George Soule, Joseph A. Schumpeter, and A. R. Burns have voiced fears for capitalism[14] which are strikingly similar to those expressed by Professor Hansen in the following statement: "It is no longer possible to accept the thesis that cycles of prosperity and depression may be complacently regarded as a characteristic of a system of free enterprise and private property. In a modern world no system can survive which permits the continued recurrence of serious depres-

[13] See, for example, the discussion of governmental functions and expenditures in chap. 9.

[14] See John Ise, *Economics*, New York, Harper & Brothers, 1946, pp. 572, 573.

sions. Should it prove true, as some still argue, that periodic depressions are an inevitable concomitant of private property and free enterprise, then this system is doomed."[15]

Conclusion. In bringing our discussion of business cycles to a close, several questions of general significance may be raised. Is it true that the degree of economic stability attainable is in direct proportion to the economic control possessed by the government? If so, to what extent are we willing to sacrifice our present individual freedom of initiative in the interests of increased stability? To what extent can stability be attained without acting as a deterrent to the normal tendency of our economic system to expand? It is with a recognition of the problems set forth and implied in these questions that attempts to find a solution of the business cycle must be made. No phenomenon in the economic world has more serious consequences or presents greater difficulties than the one we have been examining. Indeed, the knowledge and understanding needed for an adequate solution of this problem are still largely lacking. For the present, at least, the problem must be approached experimentally, in the hope that we may come across clues which will lead us eventually to the development of a satisfactory solution.

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1. Distinguish between an index of production and an index of the volume of trade.
2. Distinguish between seasonal and random fluctuations in the volume of trade.
3. What is meant by the "trend" of production?
4. How can the extent of cyclical fluctuations in business activity be measured?
5. What are the four periods of the business cycle?
6. What are the characteristics of each period in the cycle?
7. What types of factors exert an influence upon the cycle?
8. What is the principal weakness of purely psychological explanations of the cycle?
9. What is the distinction between a monistic and a pluralistic explanation of the cycle?
10. Describe the conditions existing at the peak of prosperity.
11. Why is a period of prosperity inevitably followed by a crisis?
12. What conditions existing during the depression period give rise to a recovery movement?
13. What is meant by the "self-generating" character of the cycle?

[15] *Postwar Economic Problems,* p. 10.

14. What arguments might be advanced against the desirability of attempts to stabilize business activity? What merit do these arguments possess?
15. Why is it probable that no single device will succeed in achieving stability?
16. What relationship is there between price stability and cyclical stability?
17. What is the principal value of a public works program in connection with the cycle?
18. How might the payment of unemployment benefits influence cyclical movements?
19. How should the funds to finance a public works program during a period of liquidation or depression be raised? Why?
20. When and from what sources should the funds with which to pay unemployment benefits be secured? Why?
21. Is it possible to secure stability through the direct control of production? Why or why not?
22. What characteristics of our present economic system tend to make cyclical fluctuations almost inevitable?
23. Distinguish between reform, relief, and recovery.
24. Describe the governmental attempts at (a) relief, (b) recovery, and (c) reform, since 1929.
25. What additional governmental powers might have contributed to the success of the recent recovery efforts?
26. Outline briefly the "Keynesian approach" to the problem of unemployment.
27. Explain the necessity for "offsets" to savings if depression is to be avoided.
28. What part might government play in the provision of full employment? Why should not some other agency perform this function?
29. Define "full employment."
30. Why did not extensive governmental spending in the post-1929 period bring a speedy end to the depression?
31. Do you feel that governmental spending, engaged in to provide full employment, would be better than giving unemployed workers a dole? Why or why not?
32. Do you regard the proposal of the Editors of *Fortune,* that "the government should underwrite permanent prosperity," sound and significant? Explain your answer.
33. What is the nature of the criticisms that have been leveled against the Keynesian program? Do they strike you as sound or unsound, and for what reasons?

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PROBLEMS IN INTERNATIONAL ECONOMICS

PROBLEMS IN INTERNATIONAL ECONOMICS

13. Obstacles to International Trade

International trade, contrary to the opinion of many American business men, does not consist of "selling goods to foreigners." It means, rather, the exchange of commodities and services between people of different nations. An exchange of commodities and services, whether international or domestic, is, by implication at least, gainful to both the parties to the exchange. Where fraud and compulsion do not enter in, each party engaging in exchange maximizes utility by giving up something which he desires less for something that he desires more.

Some General Principles of Trade

Trade and the Money Mechanism. The fundamental nature of trade, both domestic and foreign, is obscured by the introduction of money and credit as media of exchange. Thus it appears that a man works at his occupation day after day, receives his remuneration in terms of the medium of exchange, and obtains through the use of this purchasing power the various commodities and services which he desires. What really happens is that he specializes in a certain task, produces a surplus of his product beyond his own needs, and exchanges this surplus for other goods which are turned out in a similar fashion by other specialists. Fundamentally, all trade is barter. In international trade, certain exporters sell goods abroad, and receive payment, by selling drafts, in the money of their own country. They themselves may never purchase or use an article imported from abroad. Other individuals, however, import goods from foreign lands and pay for them with drafts in terms of the foreign money. Importation and exportation appear to be separate processes, and many people do not suspect the close relation which exists between them.

If the medium of exchange is removed from the discussion of international trade, the true nature of the process becomes apparent. Commodities and services are exchanged for commodities and services. The purpose of exporting may be, for the individual exporter, to sell goods for money. But, from the point of view of the nation as a whole, the purpose of exportation is to become able to import. In other words, it is to obtain certain commodities and services upon more favorable terms than are obtainable through home production. How, then, may a nation gain most by international trade? Will it be by giving to others many commodities and services, while obtaining few from them? Obviously not. We should seek, as a people, to obtain as many commodities and services as possible, while giving to others as few as possible. Why, then, do so many persons in this and other countries take pride and delight in a growth of exports, and view with such alarm any expansion of imports? In part, at least, the confusion arises from thinking of imports and exports as purchases and sales of goods for money.

Imports Must Equal Exports. One important principle of international trade is that, over a period of time, the value of a country's imports must equal the value of its exports. A country cannot continue indefinitely to export more than it imports, or to import more than it exports. But the question at once arises, Why do we hear so much about the exports of the United States exceeding her imports, thus giving us what is called "a favorable balance of trade"? The answer is that in most popular discussions of international trade only commodities are considered and services are disregarded. It is quite possible for a country to sell more commodities than it buys year after year, but to call this a favorable balance of trade ordinarily means little. If both commodities and services are considered, there must come a time when imports will equal exports. It is not possible for a country continually to export more than it imports, because after it has been doing so for a certain period of time, forces are set in motion, familiar to every student of economic principles, which tend to reverse the situation. These forces are, under gold standard conditions, a flow of gold toward the country with the excess of exports, a rise in the general price level in that country, and a fall elsewhere. The former exporting country becomes a poor place in which to buy and a good place in which to sell, while the reverse is true of other countries, and the balance of trade changes.

The length of time necessary for this process to work itself out

varies considerably from case to case. The gold which flows to the country that has an excess of exports may be kept from influencing prices through the action of the central banking system of that country, or imports and exports may for a long time be kept in technical equilibrium by making loans which will cover the deficiency that would otherwise exist in the exports of other countries. In the long run, however, an export balance of trade will tend to be reversed.

If the trading countries are off the gold standard, the equilibrating forces are somewhat different. If, for example, the United States has an excess of exports to other countries, the rates of exchange on these countries will tend to be at a discount in the United States, because, in this country, many exporters will need to sell bills of exchange to the banks in order to collect payment for their exports, while but few importers will have to buy bills of exchange in order to pay for imports. As the banks' foreign balances become excessive, the rates of exchange will fall.

But the discount on foreign exchange in the United States will tend to check exports and stimulate imports. Our exporters will not be able to charge higher prices than before in foreign countries; and they will receive fewer dollars than before, when they convert these prices into American money, because of the discount at which foreign exchange is selling. Importers, on the other hand, can buy the foreign exchange they need more cheaply than formerly, and yet these foreign bills of exchange will go just as far as before in buying goods abroad. The result is that exports, which had exceeded imports, are reduced, and imports, which had been less than exports, are increased, with the net effect that by and by the excess of exports will disappear. A similar argument applies to a country which starts with an excess of imports.

The Gain from International Trade. The purpose of international trade, from a national point of view, has been said to be the purchase of certain commodities and services upon more favorable terms than those on which they could be produced by the nation for itself. We of the United States, for example, obtain through international trade many products, such as coffee and tin, which we could produce for ourselves only with the greatest of difficulty, if at all. Here the gain from trade is clear, because other countries have an absolute advantage over the United States in the production of such articles. However, it is also advantageous for us to

obtain from other countries certain products which could be produced in this country with equal or greater facility, in order to leave our land, labor, capital, and enterprisers free for use in those lines of production in which our effectiveness or productivity is still greater.

A similar case may be found among individuals. A successful manufacturer may chance to be skilled as a mechanic. Perhaps he could repair his own automobile with a skill equal to, if not greater than, that of a garage mechanic. Would it pay him, then, to spend a portion of his time working on his car? Clearly not, for he will be sure to spend his time best in that occupation in which his advantage over other men is comparatively greatest. Similarly, on a larger scale, a nation benefits most by devoting its energies to those lines of production in which it has the greatest comparative advantage, or the least comparative disadvantage. This does not mean, as so many seem to believe, that each nation should produce only the one product in which its effectiveness is greatest. Many lines of production may well be followed in every country. Just where the line should be drawn between things that should be produced at home and those which should be imported is very difficult to say, but it is certain that in most countries, and particularly in the United States, many commodities are produced at home which could be imported to much greater advantage.

The Case for Free Trade. The case for free trade is the case for the world-wide geographical specialization of labor. If every country specialized in those lines of production in which its effectiveness is greatest, the resources of the world as a whole would be used in the most productive way. The result would be the production of the greatest possible total of all commodities and services. When these economic goods were distributed on the basis of free trade, each nation would obtain a greater sum total of enjoyable goods than would be available through any other process.

Restrictive Devices in International Trade

The Prevalence of Restrictive Trade Policies. While we should not rate highly the intelligence of an individual who tried to gain economically by giving away as much economic goods as possible in return for as little as possible, many nations have tried to gain by the adoption of a similar policy. That is, in spite of the weighty arguments for freedom of trade, most nations have adopted policies which greatly restrict the international exchange of goods. Particu-

larly after World War I was it true that large numbers of nations, whether or not they were formerly worshipers at the shrine of restrictionism, adopted protective tariffs and other restrictive devices.

The Protective Tariff. Under a protective tariff, certain goods produced abroad are made dutiable at rates designed to exclude these products, thus leaving the home market free for exploitation by domestic producers turning out the same kinds of goods. If, for example, a certain grade of cloth can be obtained from England for 25 cents a yard but cannot be produced in this country for less than 35 cents, then a duty of, say, 15 cents a yard is levied upon this grade of cloth, so that our wants will be satisfied by domestic manufacture, if satisfied at all. When similar duties of varying amounts are applied to hundreds or thousands of articles, the result is a "protective tariff." Many rates are more than sufficient to exclude the foreign products, while others are, in effect, low enough so that imports continue to come in to some extent despite the duties. But the purpose of the protective tariff is clearly the exclusion of foreign goods.

The Use of Subsidies. Besides the protective tariff, other measures are taken by nations to control the volume and direction of international trade. Some of the results of a protective tariff can be obtained by using subsidies, which are direct governmental grants to specified industries. When the government pays an industry a given amount on each unit of its output, the industry can sell its product at a price lower than full costs of production. This low price for the domestic product makes it difficult for foreign producers to compete with domestic producers, and relatively easy for the subsidized industry to sell in foreign countries, other things being equal. The price a government pays to maintain a subsidy is readily ascertainable, so that it is clear just which industries are being favored and to what extent. Subsidies have not been an important instrument of trade policy in the United States.

Indirect Protection. Domestic industries may also be protected by sanitary regulations applied to imported food products, veterinary laws, regulations requiring that imported goods bear a distinctive mark indicating their country of origin, and regulations governing the granting of public contracts, which specify that domestic materials must be used or require materials to come up to certain specifications. All of these measures may have legitimate and nonprotective uses, but they may also be designed to discriminate against

foreign goods. When the cost of marking a product to indicate the country of origin is greater than its original cost of production, or when the specifications made in public contracts are such that only domestic producers can meet them, these measures may be quite as effective as a tariff in protecting home industries. In the United States, the Pure Food and Drugs Act, the Meat Inspection Act, and the Horticultural Quarantine Act have operated in some cases to furnish such protection.

The Use of Import Quotas. Import quotas have been used to protect domestic industries chiefly since 1930, and are now employed in more than a score of countries. Their use involves laws or executive decrees which limit (by value, quantity, or weight) the imports of certain articles that may enter the country in a specified period of time. The countries using this device may have both maximum and minimum quotas for individual exporting countries, or they may give special concessions to countries which grant similar concessions in return. The regulations governing import quotas vary widely as between countries in the methods of allocating the quotas among countries which export the specified articles, the time periods in terms of which the quotas are stated, the units in which the quotas are stated, and the base periods on which the quotas rest.

Import quotas may be more effective than tariffs in protecting domestic industries. Normal tariff rates may lose their effectiveness when foreign currencies are being devalued rapidly, when other countries are dumping goods abroad at unusually low prices, when other countries are granting subsidies to their exporting industries, or when there are great disparities among other countries in the cost of production of certain goods. In such cases, a tariff may fail to exclude imports, and import quotas may provide surer protection. A protective tariff, once enacted, is difficult to change, but import quotas are flexible. On the other hand, import quotas, unlike import duties, do not provide revenue, and are more likely than a tariff to disrupt existing international trade relations. Even more important, perhaps, is the fact that import quotas cause goods to move between countries under governmental permit, instead of moving under the influence of price-cost relationships.

Foreign Exchange Controls. Many countries today control the total volume, specific content, and direction of their international trade. Foreign exchange controls usually operate through a central system for clearing foreign exchange bills. The central bank of the

country, or a special agency created for the purpose, is given the power to establish buying and selling rates for bills of exchange, and to deal in foreign exchange. Another agency (perhaps the ministry of commerce or finance) parcels out available supplies of foreign exchange among importers. Exporters of the country are required to demand foreign currencies for goods exported, and to sell their exchange to the central authority which sells it again, to approved importers, at a profit.

Foreign exchange is sometimes allotted on the basis of priority lists, exchange being granted to importers of foods, raw materials, partly processed materials, and finished manufactures on the basis of the importance and desirability of classes of imports as indicated by the priority lists. In addition to such priorities, some goods may be placed on a free list, so that they can be imported at any time, while others may be completely banned and the use of foreign exchange for their importation forbidden at all times. Sometimes foreign exchange is allocated on the basis of the countries from which importers wish to bring goods, so that trade may continue to be divided among countries in the proportions which prevailed before exchange control was established. In certain importing industries, trade associations may be allowed to allot foreign exchange to individual importers, or individual importers may be allowed to share the foreign exchange allotted to a given industry on the basis of relative imports in some past period.

Like the import quotas discussed above, foreign exchange controls are a more flexible instrument of trade policy than protective tariffs. They may be very useful in emergency situations, and their results are more definite and more easily controlled than those of protective tariffs. On the other hand, foreign exchange controls are complicated and expensive to administer, they often lead to favoritism to particular industries or companies, and are particularly likely to divert trade from its natural channels and upset existing trade relations. Foreign exchange controls are not simply a device for protecting domestic industries. They may be used to stop the movement of gold from a particular country, to stabilize exchange rates, to prevent an outflow of capital, to make sure of obtaining necessary imports, to serve as a bargaining tool in international relations, or for other purposes. Usually, however, they are employed to limit and restrict the volume of international trade, and frequently they give protection to domestic industries.

Blocked Accounts. Foreign exchange controls may serve to bring current imports and exports into balance, but sometimes a country which imposes such controls may be heavily in debt to other countries and may have to make large annual payments on account of interest and principal. When such a debtor country cannot expand its exports and is unable or unwilling to decrease its imports sufficiently to allow these outgoing payments to be made, its government may direct that the payments be made to banks in the home country but forbid their transfer to the creditor countries. These "blocked accounts" may then be used by their owners for various purposes *within the debtor country*—to pay for travel or study, to make investments in real estate, securities, or business enterprises, or to purchase goods for export. Thus, the blocked accounts are another device for lessening pressure on the international trade, the supply of foreign exchange, and the gold reserves of the country.

Clearing Agreements. Trading countries sometimes enter into clearing agreements to provide for the settlement of commercial obligations as a whole. A fixed exchange rate between the monies of the two countries is agreed upon, and a governmental agency is set up in each country to handle trade transactions. Importers then pay the domestic authority of their country for goods imported, instead of paying the exporters of the other country, while exporters receive payments from their domestic authority and not from foreign importers. In this way, the obligations arising from trade are settled within each country, and the use of foreign exchange is avoided so long as the total imports and exports of the countries are kept in balance. While clearing agreements are ostensibly used to expedite the payment of foreign obligations, it is obvious that the governments engaging in these agreements are thus enabled to control the volume and content of their international trade, and afford protection to domestic industries. Clearing agreements may also contain provisions for the settlement of outstanding debts between the countries, or separate payment agreements may be drawn up for this purpose.

Restrictionism as a World Policy. Since territorial division of labor and freedom of trade would bring the greatest sum total of enjoyable commodities and services to the world as a whole, it is true that restrictive measures are a tremendous source of economic loss when considered from this point of view. They cause the resources of the various nations of the world to be used, in many in-

stances, in lines of production to which they are ill adapted, and the gains which would result from the application of the principle of geographical division of labor are thus lost. The result is a much smaller total amount of goods for the world as a whole than the maximum which could be obtained. But the people of different nations do not often or seriously consider world advantages or disadvantages. Personal or local advantages are usually the prime considerations of immediate importance, and national advantage is thought to be the ultimate goal to be attained.

The Protective Tariff as a National Policy

Until the outbreak of World War II the protective tariff was the only device of any great importance used by the United States to control international trade and protect domestic industries against foreign competition. Therefore our analysis of restrictionism as a policy for a single nation will be conducted in terms of the protective tariff, but many of the arguments and conclusions which are developed will apply also to the various other restrictive devices which have been in general use.

The Protection of "Infant Industries." One of the earliest and strongest arguments for the protective tariff has to do with the encouragement of young industries. So far as other countries have advantages over us in production which rest upon natural conditions, there is little that can be done about it. But, in the early days of a country, many advantages in production possessed by other countries are of the acquired sort; that is, the foreign industries are temporarily more productive because of the advantage of an early start and years of practice in these lines of production. To accept this condition as natural and permanent, and to buy the products of these industries from foreign countries continually, may be to disregard the young nation's best interests. For it may well be that, if the young and temporarily inefficient industries are protected from foreign competition for a time, they will develop in size and efficiency until their products can be turned out more advantageously than those of other countries. Clearly, a nation should produce goods at home whenever it is more advantageous to do so than to obtain them from other countries, and it is anticipated in the case of infant industries that the gains to be realized after the industries have grown up will be more than sufficient to compensate for the losses sustained while protection is necessary.

This argument is, therefore, valid to some extent, but its validity is weakened by two circumstances. In the first place, it is impossible to decide with accuracy in advance just which industries will eventually become strong and self-sustaining. The policy of the United States has been to grant protection whenever it was asked, and it is certain that some of the industries protected must have been greatly stimulated by our tariff. On the other hand, it is equally certain that some industries have been kept alive up to the present which should have been permitted to die a peaceful and natural death a hundred years ago. Such industries have always been dependent upon the tariff for their existence, and in all probability always will be. The second circumstance is that industries, however great and efficient they may become, never feel that they are sufficiently grown up to give up tariff protection and face foreign competition. The steel industry in the United States, for example, would be considered by most persons a particularly lusty infant, and yet it has not insisted that it be allowed to make its way in the world without protection. Whatever may have been the validity of the infant industry argument in the past, it is certain that for the future it must carry very little weight.

The Home Market Argument. Ignorance or disregard of the basic principles of international trade enables protectionists to advance what is called the "home market argument." It is contended that the exclusion of foreign products from the country will leave the home market entirely to domestic producers, thus giving them a new market in addition to that which they already enjoy. Production and employment will be stimulated, it is said, and wage conditions improved. But it is a fundamental principle of international trade that the exports of a country must equal the imports in value over a period of time, and that if a country will not import, it cannot continue to export. To the extent that the protective tariff shuts out imports, our exports must eventually suffer, and the home market is built up only at the expense of the foreign market. The home market may be slightly the more desirable of the two, or it may be less desirable. The question is not one to be decided in an offhand manner. In any case, however, no large additional market can be created by the tariff.

Wages and the Tariff. The most effective argument for protection, from the point of view of obtaining from the people of this country a sufficient number of votes to authorize the continuance of the policy, has to do with the effect of protection on wages. At times

it has been held that the protective tariff is the cause of high wages. Does not the tariff permit the protected enterprisers to charge higher prices than they could otherwise charge, and do not the higher prices lead to higher wages for the workers? This line of reasoning puts the cart before the horse. According to the theory of opportunity costs, enterprisers in protected industries have to pay, for units of the factors of production, prices which are as high as these factors can command in other industries. The combination of the factors of production in the industries requiring protection, however, is for some reason not so effective as in other industries, so that the products of the former cannot be turned out at prices which will admit of effective competition with similar foreign-made products. As a result, these industries need a tariff because it will permit them to charge higher prices than could be obtained in competition with the industries of other countries, and it will enable them to continue producing while paying the current prices for the factors of production. Since the market rate for labor is more than could be afforded in these industries if the tariff were not in effect, it is true in a sense that the protective tariff has the effect of bolstering up wages in these particular fields of business.

There is, however, no reason to suppose that higher wages will be paid for labor of a given grade in protected industries than elsewhere, or that wages in general will be raised by the tariff. The relatively high level of wages in this country depends upon the relatively high effectiveness, or productivity, of labor. Wherever the productivity of labor is high, wages tend to be high, regardless of the policy used in international trade. The United States glories in the possession of a comparatively high level of both money wages and real wages under a protective system, and yet England is ordinarily second only to us in both respects under a system which until recently has been practically free trade. It would be most heartless of us to allow any of our people to live in misery and want because of insufficient earnings, if their condition could be improved by the simple expedient of enacting a higher protective tariff. That it could not be so improved reduces the high-wage argument to an absurdity. Our conclusion, then, must be that the most probable effect of the tariff on wages is to reduce real wages by causing the prices of many commodities to be higher than they would be without the tariff.

Protecting the American Standard of Living. Many people in this country believe firmly that, though high wages are not caused by the protective tariff, the maintenance of a high level of wages and a

good standard of living depends upon the tariff. The argument runs along these lines. The wages and the standard of living of workers in this country are high, and we take pride in the fact. But our enterprisers, because they pay high wages to these workers, necessarily have high costs of production and are rendered unable to compete under conditions of free trade with the enterprisers of other countries, who can secure their workers for much lower wages. Under the protective tariff, the cheap goods made by foreign "pauper laborers" are shut out, and our wages and standard of living can be maintained. If the barrier were once let down and a flood of cheap goods came into this country, our own enterprisers would be compelled to shut down and throw men out of work, or else keep their plants running by reducing wages to a point which would make the maintenance of the American standard of living impossible.

The flaw in this argument lies, of course, in the statement that high wages necessarily mean high costs of production. This statement seems unquestionably true to most persons who receive wages and to many others, and yet it is not necessarily true at all. No accurate estimate of labor cost can be made unless two facts are known: (1) the rate of wages paid, and (2) the amount of work turned out for the wages. High wages and large productivity of labor may very well mean low labor cost, while low wages and very low productivity of labor often result in a high labor cost. The truth of this statement can be established by reference to facts which are familiar to all. Money wages in the United States are the highest in the world. If high wages necessarily mean high costs of production, how does it happen that we can sell commodities to the value of billions of dollars a year ($4,021,000,000 worth in 1940) to the people of foreign countries? Why, with their low wage rates, can they not undersell us in everything? The answer is that our workers turn out so much product per unit of wages that costs are in reality low, not high, in these lines of production.

Does a country with a high wage level and standard of living have anything to fear from free trade with a country having a low wage level and standard of living? We think not. England with high wage rates and standard of living engaged in trade for many years on a basis of free trade with China, where these labor conditions are exactly reversed, but there was no noticeable tendency to drag English laborers down to Chinese wages and standard of living, or

to raise Chinese laborers to the English level. It is important, then, to remember from this discussion that high wages and satisfactory living standards are dependent upon high effectiveness or productivity of labor, rather than upon the maintenance of a protective tariff.

The Tariff and Employment. The contention that the protective tariff increases employment is related to the high-wage and home market arguments. If we shut out foreign products, it will be necessary to produce our supplies of these goods in this country, and we shall have more industries than otherwise. These industries cannot run without laborers and there will be much additional employment created for our working men. This argument, of course, disregards the familiar fact that if we will not import, we cannot continue to export. As men are put to work producing the goods which are no longer purchased abroad, other men are thrown out of employment in industries producing for the export market. The effect of the whole process is to shift large amounts of capital, labor, and land to the production of goods which could be obtained more advantageously from abroad, instead of using these factors in our export industries where they are especially productive. No large, additional source of employment is created by the tariff. We do, by erecting tariff barriers, make it more difficult for us to obtain the goods we desire, but that is a doubtful advantage. We could also "increase employment"—that is, provide more hours of work—if we impeded production by equipping our workers with ball-and-chain or handcuffs, but apparently our protectionists have overlooked the possibilities of this procedure.

The Protection of Vested Interests. It is sometimes thought necessary to continue the policy of protection, once it is begun, even though some other policy would be more desirable if we were to begin over again. The reason given is that, under the guaranty of the tariff that foreign competition will be excluded, individuals have made large investments in protected industries and workers have adapted themselves to conditions in these lines of production. If protection is not continued, all of these individuals will suffer losses. It will be seen, however, that this is not an argument for the protective tariff, but, rather, one against the abrupt removal of protection. Economists generally would concede that the reductions in protection should come gradually, rather than suddenly, but they hold that in any event reductions must be made.

The Tariff as an Instrument of National Preparedness. When no other argument prevails, protectionists of the old school fall back upon the necessity for national preparedness. Under a system of free trade, the United States would be largely dependent upon other nations for certain commodities, and would be subject to the ever-present danger of having her supplies of these products cut off in time of war. Let us, then, maintain the protective tariff, and thus insure within this country the production of as many essential products as possible, say these protectionists. What if this policy does mean that, to a certain extent, our productive resources will be used ineffectively, and a smaller sum total of commodities and services than the maximum will be produced, just so long as our national security is promoted? This argument, of course, admits the direct uneconomic effects of protection and, in addition, falls short of the mark in another respect. To try to become a self-sufficing nation is to follow a narrow nationalistic policy, and the instrument of this policy, the tariff, is a very prolific source of international ill feeling and friction. Though it may be admitted that it is a serious matter when our supplies of important commodities are cut off in time of war, we may go still further and recognize the fact that when nations cooperate with and are dependent upon one another on the basis of freedom of trade, the likelihood of war is lessened to a marked degree.

Protection Against Dumping. In recent years the protective tariff has come to be supported on grounds which appear to be quite different from those which are described above. The tariff is advocated, for example, as a protection against the dumping of foreign goods in this country. "Dumping" is the term used when the practice is carried on by the people of other nations. When we ourselves engage in such practices, we regard them merely as good business. Dumping has been variously defined, but one useful definition describes it as the sale of goods at a lower price in one market than in another. If, for example, a French perfume sells at the equivalent of twenty dollars an ounce in France, and is marketed in the United States by its producer for ten dollars an ounce, dumping is taking place. Dumping is not a new source of worry for Americans. Indeed, our first tariff to contain any considerable element of protection was passed shortly after the War of 1812, largely because of the expressed determination of British producers to sell goods in this country for any price they would bring, or even to give them away

if need be, in order to stifle the young industries which had sprung up in America and thus recapture our market for themselves.

The consideration of dumping gives us an interesting sidelight on the attitude of Americans toward foreign products. If the foreign products are offered at higher prices than those at which identical products could be turned out in this country, we are often inclined to purchase the articles from abroad as being of superior quality, or for some other reason. To offer us goods at the same prices for which they could be produced here is considered reprehensible, and our suspicions are at once aroused. If foreign producers plumb the depths of infamy by offering to furnish us certain products more cheaply than we could produce them ourselves, we begin to look for the "pauper laborer" in the woodpile and enact a tariff to protect ourselves from this threat to our economic welfare. Finally, to include the worst possible case, if foreigners should offer to give us certain goods free of charge, we would probably go to the extreme of cutting off all trade relations with the offending countries.

Since everyone is presumably interested in getting as many commodities and services as possible at the smallest possible cost, why do we object to the sale of goods to us by the people of foreign countries at very low prices? It is because of the fear that this process will not be continued indefinitely. The sale of goods at these low prices might go on so long that we would become dependent upon others for them and give up their domestic production, only to find the prices raised later above the level at which the goods could be produced in this country. For this reason it is considered well to avoid goods which are offered on suspiciously favorable terms. However, dumping can be guarded against without continually maintaining high duties which permit the mulcting of domestic consumers.

The Tariff and Economic Stability. The argument that the protective tariff may be of benefit because it promotes economic stability is close kin to the home market argument. It has been admitted that the tariff may be used to preserve the domestic market for American producers at the cost of reducing our foreign markets to a similar extent, but which market is the more advantageous appears to be a difficult question to settle. The economic stability argument holds that the domestic market is definitely more desirable, because it is more stable. "Let us produce and consume by ourselves to a large extent and shut out disturbing influences. The result may

be, of course, that we shall have a smaller sum total of commodities and services to enjoy than otherwise, but may it not be better to have a smaller flow of goods, if the flow is more constant?"

Our answer to this question may well be favorable, as is anticipated by those who advance the argument, but it is at once necessary to ask whether economic stability can actually be obtained by this policy. To what extent is our economic instability the result of importing from and exporting to foreign countries, and thus likely to be affected by the tariff? It is extremely doubtful whether the major factors in the problem of economic instability will be much affected by the tariff policy. Even though foreign supplies of various products are excluded from the domestic market, it will still be possible, unless domestic production is controlled, for our producers to turn out larger amounts than will be taken by consumers at prices sufficiently high to enable the producers to recover their costs of production. The demand for different goods will not be controlled by a protective tariff and can vary as in the past. Neither can the tariff prevent an overextension of credit in this country. It will consequently appear to most observers that there is room within a country such as the United States for a considerable degree of economic instability, even if outside influences could be shut out.

The Scientific Tariff. Since the early years of the twentieth century there has been much talk about the true principle of tariff-making, which is that the tariff rates should be just high enough to cover the difference between foreign and domestic costs of production. No favors or special privileges would be granted to domestic producers. Indeed, the tariff would be used only to guarantee a fair contest between foreign and domestic producers, according to its sponsors.

This principle, as it is ordinarily presented, sounds very fair and reasonable, but it will not bear close examination. In the first place, it would be difficult, if not impossible, to ascertain the domestic and foreign costs of production of a wide variety of articles. It is a sufficiently troublesome problem to obtain an approximation of domestic costs, and even greater difficulties are encountered abroad, where information of this sort is considered strictly private and is almost invariably withheld from investigators. Great expenditures would certainly be necessary to secure any worth-while information, and whatever data were obtained would probably be out of date before they could be used as the basis of tariff legislation.

Moreover, even if the principle could be strictly followed, the result would be disheartening. Trade is beneficial because it enables us to obtain goods more cheaply than we could produce them for ourselves. The effect of a tariff in equalizing costs of production would be to remove and destroy all the advantage which exists for us in international trade. Therefore, such trade would be wiped out so far as the United States is concerned. Then, too, let us consider what would happen in this country. All commodities would be protected and all that were consumed by us would be produced here, whatever the cost might be. If the commodity in question were bananas, the procedure would be to find out how much more it would cost to produce them here than in Central America, and then apply a tariff rate sufficiently high to equalize costs of production. The result, so far as most consumers were concerned, would be to raise their price to a prohibitive figure. If the good in question were rubber, silk, or coffee, the same procedure would be followed.

It might be argued that no one would favor carrying the principle to such extremes, but it is difficult to say just where it would stop. We have records of speeches by United States Senators in which they state that they would be willing to see duties of 300 or 400 per cent applied, if necessary, in order to accomplish the purpose of the tariff. But if we are to go as high as 400, then why not to 800, or to 2000 or 3000 per cent? Moreover, one Senator has favored the draining of the Everglades of Florida so that certain semi-tropical products might be raised there; thus it may be seen that the protection of the commodities mentioned in the preceding paragraph is quite within the range of possibility. All in all, the "true principle" of tariff-making is a ridiculous and worthless one.

Conclusion on the Tariff as a National Policy. Although the argument in the present section has been conducted in terms of the United States, as being of greatest interest to American readers, the conclusions which have been reached will apply, changing as conditions change, to other countries as well. The benefits that have been claimed for the protective tariff have been seen to exist largely in the minds of those who find it desirable to support protectionism for some other reason than the reasons they advance. Where benefits have resulted, it is usually true either that they do not continue into the present, or that they could have been obtained more economically by some other method.

The losses under protection are beyond question. The productive

resources of each country are diverted from industries in which they would be especially productive to other lines in which their employment is relatively ineffective. The desired commodities and services are obtained under difficulties, and the sum total of goods available for the enjoyment of the people of the country is smaller than otherwise. This ill treatment of all the citizens as consumers results in gains for some enterprisers, but not for others. If the higher prices that can be charged under the protective tariff are just sufficient to enable producers to continue in business in these ineffective industries, then (under conditions of competition) each factor of production will receive payment at the going rate and no more, and the loss to many persons in terms of higher prices will not be compensated by the gains to others. In other cases the tariff will allow prices to be sufficiently high to permit profits, and sometimes very large profits, to the owners of the protected businesses. It is axiomatic, however, that they never gain as much in profits as the people on the whole lose as consumers. In any event, this is taxation or exploitation of the many for the benefit of the few. Whether or not some individuals profit from the use of the protective tariff, it is to be condemned severely on economic grounds. And, of course, the same general conclusions must be reached with respect to the use of other devices for restricting international trade.

Protectionism in the United States

The United States as a Creditor Nation. Having concluded our general discussion of protectionism as a national policy, we must now note that, as a practical matter, the use of this policy by the United States has been particularly unfortunate in recent decades. In the middle of the last century, this country was experiencing an "unfavorable balance of trade," that is, there was an excess of merchandise imports over exports. This condition arose, in part, from the fact that the country was a borrowing or debtor nation at the time. So long as we continued in that rôle there was little outspoken criticism of our tariff by other countries. People interested in collecting from debtors seldom discriminate against them, or interfere with their chances of becoming prosperous and able to pay their debts. But after the beginning of the last quarter of the nineteenth century our trade balance and credit position changed. During and after World War I our loans to other countries were tremendous, and the United States took a commanding position as a creditor nation.

At the close of 1930, the private investments of the United States in foreign lands were estimated at $14,900,000,000 to $15,400,000,000,[1] and the discounted value of the debts of other nations to the government of the United States amounted to $7,000,000,000. Our loans and investments abroad were not made in the form of money, but consisted of economic goods. If the loans were to be repaid, if our investments abroad were to be retrieved, and if we were to receive income from our loans and investments, the payments had to be made to us not in money, but in commodities and services. If other countries were to pay the United States, say, $500,000,000 in a given year, it was necessary for their exports to exceed their imports by this amount. By the same token, we could receive such a payment only by allowing our imports to exceed our exports by the same amount.

In the face of a desire to collect our debts and the knowledge that the payments had to be made in the form of commodities and services, we twice raised our tariffs against imports after World War I and thus made it increasingly difficult for other countries to send us goods. Our Tariff Act of 1922 gave us the highest level of tariff duties in the world, except for one other country, and decidedly the highest among the important industrial nations of the world.[2] The Tariff Act of 1930 was no improvement, for a study of comparative ad valorem rates in the two Acts based upon imports for consumption in 1928 showed an increase in the average rate of duty from 33.22 to 40 per cent, so far as items were comparable in the two Acts.[3] This high tariff policy was clearly inconsistent with our position as an outstanding creditor nation.

The Changing Nature of Our Exports. In the more distant past, foreign countries protested but little against our tariff policy, not only because the United States was a debtor nation, but also because our exports consisted predominantly of raw or semi-manufactured products which these countries greatly desired and against which they would not discriminate. Since the beginning of the last

[1] United States Department of Commerce, "A New Estimate of American Investments Abroad," *Trade Information Bulletin No. 767*, Washington, Government Printing Office, 1931, p. 1.

[2] The League of Nations, Economic and Financial Section, International Economic Conference, *Tariff Level Indices*, Geneva, The League of Nations, 1927, especially p. 16.

[3] The United States Tariff Commission, *Comparison of Rates of Duty in the Tariff Act of 1930 and in the Tariff Act of 1922*, Washington, Government Printing Office, 1930, p. 1.

quarter of the nineteenth century, the trend in our exports has been away from raw and partly finished products toward manufactured goods. These are goods which can be obtained from other countries as well as from the United States, or can be produced in the countries to which we export them at only slight differences in cost in many cases. Consequently, every upward revision of our tariff has tended to bring in its wake a host of discriminations and retaliations against the United States. Of course, other countries do not ordinarily discriminate openly against our products, or enact tariff laws which are avowedly retaliatory, because our President has been given wide powers in dealing with goods from countries which clearly practice discrimination and retaliation. But it is not difficult to read between the lines of the changing trade policies of other countries.

The Difficulty of Changing the Tariff. In spite of the apparent desirability of changing our policy with respect to international trade, it seemed almost impossible, up to the middle of the 1930's, to alter the prevailing sentiment in favor of the protective tariff in the United States. Many millions of our people are classed as wage earners, and these workers had been carefully "educated" in the matter of the tariff over a long period of time. That the protective tariff brings with it "high wages and full dinner pails" was to many workers much more than a mere political campaign myth. It was to them a tradition, a religion handed down from one generation to another, and did not appear to be open to argument. The responsibility for the development and maintenance of this belief is easy to place.

The Influence of the Press. The tariff views of the workers as a class were largely the result of the news items and editorials of newspapers and the speeches of politicians. For many people the newspaper is the one and only form of literature, and certainly the only available printed medium of information on the tariff problem. Most of the newspapers with which one came in contact, and particularly those in the great industrial centers where large numbers of workers are found, were staunch supporters of our tariff policy. To their editorial pages the worker, if his belief in the tariff had been shaken by hard times, might turn with every assurance of seeing repeated the familiar fallacies upon which was built his belief in the benefits of protection. Even in depression, he would find there assurances that the tariff was the foundation of our prosperity in the past and is our only hope for the future. Surely, those

who depend upon the editorials of the average newspaper for an understanding of the principles of international trade must always remain in almost complete ignorance of the subject.

The Speeches of Politicians. The speeches of men in political life, as heard directly or over the radio, or as reproduced in the newspapers, also greatly influenced popular opinion on the tariff. For many years, both major political parties were in accord in favoring the protective tariff in principle, although they disagreed somewhat about particular schedules. Political talks on the tariff were almost universally worded in terms of the ancient fallacies with which we are now familiar, and yet they proved convincing to most wage earners and to many others. The candidate for public office would say, "Vote for me. My party stands for the protective tariff, and the tariff is the cause of all your prosperity." People would flock to his standard. If the same man had said, "Vote for me, because my party stands for the protective tariff, and the tariff is the cause of the heavy rains which have brought you relief from the drought from which you have been suffering," these same people would have laughed at him. And yet the tariff would ordinarily be as truly responsible in the one case as in the other.

Students often ask, Were our political figures, our Senators, and our Congressmen so ignorant of the principles of international trade that they really believed the arguments they advanced about the tariff, or were these contentions made for a purpose? While many of the arguments were no doubt made in all sincerity, it seems very unlikely that all of our political leaders were really deceived by some of the absurd statements about the tariff, unless it is true that a man can repeat a thing so often that, despite its falsity, he eventually comes to believe it himself.

Senators and Representatives are elected from states and from districts within states. Since the interests of the people as consumers are rarely considered in Congress, the business of each member of that body with regard to the tariff is to get as many favors as possible for the business interests of his district. Some businesses within a district might be making large profits behind the tariff wall, others might be dependent upon the tariff for their very existence, and still others might not be concerned at all about it. In any case, the attempt was usually made to obtain protection for all. Many cases are on record of industries receiving a generous measure of protection where none was asked. Tariff advantages for one district could be

obtained by members of Congress only by cooperating with other members desiring favors for their own districts. Whatever the method used, each member had to look out for his own district, or powerful support would be withdrawn from him and at the next election he would be likely to find himself one of the represented, instead of being himself a representative. Many tariff speeches were doubtless made as a justification of the actions of the members, and for popular consumption at home, to convince those who were not convinced and to reassure those who were.

The Attitude of Business Men. The one discordant note in the hymn of praise for protection was the fact that many American business men were coming to view the tariff with doubt and fear. Of course, those whose businesses were dependent upon the tariff for large profits, or for their very existence, quite naturally continued to favor the policy of protection. Almost anyone in the same position would feel the same way. If a man knows that a certain policy is vital to his own interests, it is extremely easy for him to discover that this same policy is of the utmost importance for the welfare of the country as a whole.

On the other hand, the policy of protection was opposed by many of our great bankers, who sensed that restrictions on imports were great obstacles to a continuation of our foreign investment policy and to the development of New York City as an international financial center. Farmers, too, were coming to suspect more and more strongly that they had little to gain and much to lose from continued attempts to "protect" them. Finally, the owners and managers of industries which were efficient in their own right, which did not depend upon the tariff, and which were able to meet world competition, were beginning to oppose the protective tariff. Being able to meet competition, these industries were anxious to develop their exports further and gain the markets of the world, but they found themselves greatly hampered in their efforts because we refused to accept imports freely and thus made it difficult for the people of other countries to buy from us.

Recent Developments in Trade Policy

The Reciprocal Trade Agreements. The Tariff Act of 1930 did not restore prosperity in the United States, but our international trade almost disappeared in the years immediately following its passage. By 1934 the Congress of the United States was ready to enact

a law which seemed destined to go far toward modifying our tariff policy. This measure, called the Reciprocal Trade Agreements Act, authorized the President to enter into reciprocal commercial agreements with other countries for the purpose of fostering international commerce. In such agreements, the President could modify existing import duties and other restrictions in return for similar concessions from other countries. He could not, however, increase or decrease any duty by more than 50 per cent, or transfer articles from the dutiable to the free list or vice versa. The agreements could be consummated only after giving reasonable public notice of the intent to negotiate with the other countries, after holding public hearings at which those interested could express their opinions about the prospective agreements, and after seeking information and advice from the United States Tariff Commission and the Departments of State, Agriculture, and Commerce.

The policy expressed in the Act was pursued actively during the next ten years, and agreements were drawn up with twenty-seven countries, including Great Britain, Belgium, Sweden, Switzerland, Cuba, Canada, France, Czechoslovakia, Iran, Iceland, and a number of South and Central American countries. It will not be feasible for us to consider the details of these trade agreements, but we may examine briefly those concluded in 1938 with Great Britain and Canada. Under these agreements, the United States received tariff cuts or other concessions from Canada with respect to 1489 products, and from Great Britain with respect to about 450 products. Canada and Great Britain, in return, received concessions from the United States on about 450 and 150 products, respectively. The agreements affected American exports which in 1937 were valued at about $440,000,000, and American imports amounting to some $260,000,000 in that year.[4] In signing her agreement with the United States, Great Britain acted for Newfoundland and about fifty non-self-governing colonies. At that time the United States transacted about one-third of her total foreign trade with the areas included in these agreements, and the three countries together (the United States, Great Britain, and Canada) accounted for almost one-third of the world's total international trade.

Appraisal of the Reciprocal Trade Agreements. It is impossible to determine the exact effects of the reciprocal trade agreements

[4] *The New York Times*, November 18, 1938, and *Chicago Tribune*, November 17, 1938.

upon the international trade of the United States. To do so would require a comparison of our actual volume of trade in several years with the volume which would have been transacted in the absence of the trade agreements—and the latter, of course, is an unknown quantity. Our international trade is subject to so many influences that one cannot single out the specific effect of the trade agreements. Some people argue that our trade with all countries was probably affected in the same way by the general recovery of business and insist that, if our trade increased faster with agreement than with non-agreement countries, the influence of the agreements is indicated. However, this is not necessarily true. Our trade with Germany, for example, may have been reduced by resentment felt here over that country's handling of the Jewish people, her default on financial obligations, or her general program of aggression. American trade with Japan may have been similarly affected at one time by our attitude toward her invasion of China and her treatment of Americans in the war area, and may later have been increased by her heavy purchases of war materials and supplies. Since Germany and Japan were both non-agreement countries, failure to consider these matters would result in giving our trade agreements with other countries more or less credit than they deserve. It was true that, as compared with 1935, our 1936 trade with agreement countries increased roughly twice as fast as our trade with non-agreement countries, but after 1937 wars and preparation for war disturbed our trade to such an extent that it is quite impossible to estimate the effects of trade agreements.

For the most part, then, the trade agreements must be approved or disapproved on general grounds. Other things being equal, they probably had some stimulating influence on international trade, and they reduced tariff duties or made other concessions where these actions would do us the most good. Since it seemed impossible to get many nations to lower trade barriers at one time, reciprocal trade agreements probably provided the best means available at the time for increasing international trade by reducing trade restrictions. The objections to the trade agreements came more largely from small business men than from our major industries. Small business men, who had no hope of developing foreign markets, were disturbed by the increased importation of foreign products. In addition, our tariff-minded politicians and newspaper writers made a determined effort to convince the farmers of the country that the

trade agreements were detrimental to agricultural interests. The farmers were told, at one time, that our imports of cheddar cheese had increased fifteen-fold under the auspices of our trade agreement with Canada. The implication was, of course, that they had been badly injured by this development, but the tellers of the tale forgot to add that, even after the increase mentioned, these imports amounted to only 2.2 per cent of the domestic production of cheddar cheese. Similarly, the farmers were urged to protest against great increases in our imports of cream, though these imports amounted, after the increase had taken place, to only one-tenth of one per cent of domestic production.[5] In the field of manufacture, alarm was expressed over the trade agreements provision which permitted the importation of 4,800,000 pairs of shoes a year from Czechoslovakia, although these imports, if actually achieved, would have amounted to only 1¼ per cent of our domestic output.

Wartime Controls over International Trade. After the reciprocal trade agreements program had been in effect five years, World War II broke out, the United States becoming involved in the conflict late in 1941. Wartime conditions brought great increases in the extent to which the international trade of the United States was controlled by the federal government. Even before this country entered the war, our government set out to accumulate stock piles of certain strategic and critical materials, and entered into agreements with various Latin American countries for the purchase of all their available supplies of such materials. Moreover, after December 27, 1941, the government assumed complete control over the imports of a number of materials and these things could be imported only by some governmental agency.

Our foreign trade was affected also by the "freezing" of foreign assets. The freezing process was based on an Executive Order administered by the Federal Reserve Banks and the Treasury Department, and it prohibited all transactions within the jurisdiction of the United States in which the country (or its nationals) to which the order applied had any interest, after a stipulated date. The freezing process, first used in April, 1940, was extended to country after country as German conquests continued, to Germany and Italy themselves in June, 1941, and to Japan in July, 1941. Naturally, all imports and exports between the United States and any country whose assets had been frozen were automatically prohibited, unless

[5] *Foreign Affairs*, April, 1938, pp. 428, 429.

our government saw fit to issue licenses for specific transactions. This was true also of transactions between countries with frozen assets and any third country, if the transactions were to be financed by means of foreign credits held in the United States.

The freezing orders as such were not applied to the Latin American countries, but something of the same effect was produced by the promulgation in July, 1941, of the Proclaimed List of Certain Blocked Nationals. This list contained the names of persons and firms believed to be nationals of or sympathizers with the Axis countries, and located in countries of the western hemisphere. Our government forbade all business and financial transactions between citizens and residents of the United States and listed persons and firms, unless specifically permitted by licenses issued by the Treasury Department. The United States had considerable cooperation from Latin American countries in carrying out this policy, which was aimed quite definitely at depriving the Axis powers of any economic advantages they previously derived from enterprises, investments, and business connections in Latin America.

The exports of the United States were also subjected to direct control during the war period. In July, 1940, the National Defense Act provided for a general system of export control by means of licenses. This export control system was originally intended to apply to essential raw materials, machine tools, certain chemicals, arms, ammunition, and war goods in general. However, the list was increased rapidly, and soon scarcely anything included in our normal list of exports could be exported without a federal license. The export control system prevented other countries from buying here raw materials and goods which were needed in our war program, but permitted us to send all kinds of goods to countries of the western hemisphere which were collaborating with the United States in her war program. Even before our entry into the war, export control enabled us to interfere with and hamper the war activities of the Axis nations.

Finally, the lend-lease policy of the United States had an important effect on our trade. This policy was provided for in the Act to Promote the Defense of the United States, which was passed in March, 1941. This Act authorized the President to sell, transfer title to, lease, lend, or otherwise dispose of various defense goods to other countries whose defense was deemed vital to the safety of the United States. Defense articles in this connection included (1) weap-

ons and munitions of war, (2) machinery, facilities, tools, materials, parts, and supplies necessary to the production, maintenance, and repair of war weapons and goods, and (3) any agricultural, industrial, or other commodity or article for defense. The Act specified that lend-lease aid could be given under any terms and conditions which were satisfactory to the President, and that the resulting benefit to the United States could be payment in kind or property, or any other direct or indirect benefit which the President deemed satisfactory. From 1941 through October, 1945, lend-lease aid to Great Britain, Russia, China, and other allied nations amounted to about 38 billion dollars.[6] This outlay represented some 11.7 per cent of our expenditure for war over the same period.

International Trade of the United States in Wartime. Clearly, the various governmental controls which we have been describing did not all make for a decline in the total volume of our international trade. Some policies, such as the lend-lease program and the over-all purchasing agreements for strategic and critical materials, tended to increase trade. As a result, the total volume of the inter-

TABLE 19. INTERNATIONAL TRADE OF THE UNITED STATES, 1939–45 [a]

(in millions of dollars)

Year	Exports	Imports	Total Trade
1939	$3,177	$2,318	$5,495
1940	4,021	2,625	6,646
1941	5,147	3,345	8,492
1942	8,035	2,745	10,780
1943	12,975	5,375	18,350
1944	14,568	6,926	21,494
1945	11,161	6,073	17,234

[a] Source: *Survey of Current Business,* February, 1945, p. 19, and February, 1946, pp. 25, 26.

national trade of the United States, in terms of merchandise, increased year by year from 1939 through 1944, as shown by the data in Table 19. The expanding total volume of trade in this period was largely the result of sharply increasing exports; and lend-lease exports of war goods, foods, and industrial materials played a very

[6] *Survey of Current Business,* February, 1946, p. 24

important part in increasing our total exports. In 1944, for example, the total exports of $14,568,000,000 included only $3,528,000,000 of ordinary "cash" exports, whereas in 1945 cash exports amounted to $5,108,000,000 out of total exports of $11,161,000,000. Our imports in 1943, 1944, and 1945 included significant amounts of reverse lend-lease, or contributions of the Allied nations to the United States.

The Bretton Woods Agreement. While World War II was still in progress, preliminary steps were taken to lay the foundation for a revival of international trade after the war. In July, 1944, representatives of forty-four nations met at Bretton Woods, New Hampshire, and drew up the famous Bretton Woods Agreement, which provided for two international financial institutions—the International Monetary Fund and the International Bank for Reconstruction and Development. The Agreement had been ratified by thirty-eight nations by April, 1946. In this chapter, we shall consider only the International Monetary Fund, leaving the affairs of the International Bank for discussion in Chapter 14.

The International Monetary Fund. The purposes of the Fund are (1) to promote international monetary cooperation through a permanent institution; (2) to facilitate the expansion and balanced growth of international trade; (3) to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation; (4) to assist in the establishment of multilateral systems of payments between members and in the elimination of foreign exchange restrictions; (5) to make the Fund's resources available to members in order to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity; and (6) to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund is to have a total capital of 8.8 billion dollars, to be subscribed by the member nations. The United States will make the largest contribution (2¾ billions) followed by the United Kingdom, Russia, China, France, and other nations. Each member nation must express the par value of its currency in terms of gold or United States dollars. Having established such a par value for its currency, a nation may reduce this par value by 10 per cent simply by notifying the Fund. Any further reduction, however, can be made only with the consent of the Fund's management, and an unauthorized depreciation of a nation's currency may result in the suspension of

the nation from the use of the Fund. Currencies of the nations will exchange at the values set, except that rates of exchange may vary within one per cent of the official ratios.

With the Fund in operation, nations will collect for exports and pay for imports through bills of exchange, as usual. However, if a nation runs short of exchange balances to make payments in another nation, it can purchase the other country's currency from the Fund. If France, for example, needs Mexican pesos to pay for imports, she will pay francs into the Fund and secure the pesos she needs. There are, of course, limitations on this process. No nation may buy the currencies of other countries through the Fund in any one year to an amount in excess of 25 per cent of its original contribution to the Fund; and the Fund may set a limit beyond which it will refuse to sell a nation any more of the currencies of other nations until the first nation has made a readjustment of its affairs.

The point is that, when a nation has to buy foreign currencies from the Fund, it has been buying abroad more than it has been selling, and is slipping into debt. Limitations on its purchases of foreign currencies through the Fund are expected to induce it to "clean house." It can put high import duties on luxuries, and use its limited foreign exchange to purchase necessary imports. It can put pressure on its citizens to seek out markets for exports, to work harder and increase efficiency, and so on. As a result, the nation will probably sell more and buy less, and thus acquire the foreign currencies that it needs.

On the other hand, if a nation persistently sells more than it buys in international trade, and other countries have to buy its currency through the Fund, the Fund's supply of that nation's currency will become short. This is especially likely to happen to the United States in the post-war period. In such an event, the management of the Fund will officially recognize the shortage, proceed to ration the limited supply of dollars among the nations which desire them, and may issue a report setting forth the causes of the shortage and making recommendations designed to bring it to an end. A representative of the member country whose currency is involved will participate in the preparation of such a report. Under the operation of the Fund, the United States (or any other country) cannot continue exporting if it will not import, and it will be under pressure to lower its tariff so that more goods will be imported or to seek out opportunities for making worth-while loans in other countries. Either of

these developments would place more dollars at the disposal of the other countries.

The member countries may use the resources of the Fund for capital transactions of reasonable amounts required for the expansion of exports, or in the ordinary course of trade, banking, or other businesses, or to effect capital movements which are met out of a member's own resources of gold and foreign exchange; but such capital movements must be in accord with the purposes of the Fund. A member cannot use the Fund's resources to effect a large or sustained outflow of capital, and the Fund may request a member to exercise controls to prevent this use of its resources or may even declare an offending member ineligible to use them.

Under the operation of the Fund, international trade situations which in the past have led nations to abandon the gold standard, depreciate their currencies, institute foreign exchange controls, and set up barter arrangements for dealing with other countries are expected to be resolved by orderly readjustments of the countries' economic affairs. At the same time, a temporary upset or disequilibrium in a country's international balance of payments can be provided for at stable exchange rates through the Fund. The result should be a larger volume of international trade and the stabilization of international monetary relations.

Each member country must agree that it will not (1) impose restrictions on the making of payments and transfers for current international transactions, (2) engage in any discriminatory currency arrangements or multiple currency practices except as authorized by the Fund, or (3) cooperate with any non-member country in any manner contrary to the provisions of the Fund agreement. Each member country is obligated to furnish such information as is necessary for the effective discharge of the Fund's duties. This information might cover any nation's holdings of gold and foreign exchange, gold production, gold imports and exports, total imports and exports of goods, capital transactions, price indexes, and international investments and obligations. Any member may withdraw from the Fund at any time by transmitting a notice in writing to the Fund at its principal office, and the Fund may declare a member ineligible if it fails to fulfill any of its obligations.

The Fund is to be controlled by a Board of Governors, Executive Directors, a Managing Director, and a staff. The Board of Governors has general control over the Fund and is composed of one

Governor from each member country. Each Governor is entitled to cast 250 votes plus one vote for each $100,000 part of his country's original contribution to the Fund. There are twelve Executive Directors, five of whom are appointed by the five members making the largest original contributions. The Managing Director is appointed by the Executive Directors. He has charge of the operating staff and conducts the ordinary business of the Fund, while the Executive Directors have charge of the general operations of the Fund.

The Economic and Social Council of the United Nations. Another recently developed organization which may exert an influence on international trade in the post-war period is the Economic and Social Council of the United Nations. Declaring it to be the intent of the United Nations to promote (1) higher standards of living, full employment, and conditions of economic and social progress and development, and (2) solutions of international economic, social, health, and related problems, the Charter of the United Nations, drawn up at the San Francisco Conference in 1945, provided for the creation of the Economic and Social Council. This body will be composed of representatives of eighteen nations, chosen for three-year terms by the General Assembly of the United Nations. The Council will sit continuously, and may become a very important division of the United Nations, since the solution of international economic and social problems would go far toward the prevention of war.

The Council may make or initiate studies and reports with respect to international economic, social, cultural, educational, health, and related matters, and may make recommendations with respect to any such matters to the General Assembly, to the Members of the United Nations, and to the specialized agencies concerned (such as the United Nations Food and Agriculture Organization, the International Monetary Fund, the International Bank for Reconstruction and Development, the International Labor Organization, and the United Nations Aviation Organization). It may prepare draft conventions for submission to the General Assembly, with respect to matters falling within its competence, and it may call, in accordance with rules prescribed by the United Nations, international conferences dealing with such matters.

The Council may enter into agreements with the specialized agencies referred to above, defining the terms on which any agency concerned shall be brought into relationship with the United Na-

tions. It may coordinate the activities of the specialized agencies through consultation with and recommendations to such agencies and through recommendations to the General Assembly and to the Members of the United Nations. It may take appropriate steps to obtain regular reports from the specialized agencies, and reports on the steps taken to give effect to its own recommendations and to recommendations on matters falling within its competence made by the General Assembly.

The Council may furnish information to the Security Council, and shall assist the Security Council upon its request. It shall perform such functions as fall within its competence in connection with the carrying out of the recommendations of the General Assembly. Finally, it may, with the approval of the General Assembly, perform services at the request of Members of the United Nations and of the specialized agencies, and shall perform such other functions as are assigned to it from time to time by the General Assembly.

The functions of the Economic and Social Council obviously are stated in very general terms. However, if the Council is to try to find solutions for international economic problems and to promote higher standards of living, full employment, and economic progress, it will have to be concerned with international trade, restrictions on trade, international monetary relations, and international credit and investment transactions. If the Council decides that tariff walls and other restrictive devices are limiting world trade and indirectly causing unemployment and business failures, it may well seek the scaling-down or elimination of these restrictive devices. However, there is a paragraph in the charter which forbids the United Nations to deal with anything that is entirely a domestic affair of a Member, and it remains to be seen just which matters will eventually fall into this category.

Conclusion. Much praise and criticism had been heaped upon the international organizations which we have been describing even before they started to function, but an effective appraisal of them can scarcely be made until they have functioned for several years. Their success will clearly depend, to a great extent, upon the spirit and intelligence with which they are operated; for experience indicates that it is impossible to set up foolproof organizations for the stimulation of international trade or the stabilization of international finance. If the organizations operate successfully in these fields, we may eventually see the happy day when the story of the

benefits of restrictionism will be pulled down from the shelf of works on economics and placed among the fairy tales where, for the most part, it indubitably belongs.

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1. "International trade, like domestic trade, is fundamentally barter." Explain.
2. Why does the economist contend that the imports of a country must equal its exports over a period of time?
3. How would the absence of trade restrictions tend to maximize the gain which the nations of the world could derive from international trade?
4. Explain the general nature of a protective tariff.
5. "Domestic industries may be protected indirectly as well as directly." How?
6. Why may import quotas be more effective than protective tariffs in certain situations? Explain.
7. How may foreign exchange controls be operated to afford protection to domestic industries?
8. "Foreign exchange controls may be set up for many purposes but they often restrict trade and protect domestic industries." Do you agree? Why or why not?
9. Discuss the relative merits of foreign exchange controls and protective tariffs.
10. Compare clearing agreements with foreign exchange controls proper.
11. Could we, by means of the tariff, monopolize the domestic market and maintain our export trade at the same time?
12. "The superiority of one country over another in a branch of production often arises only from having begun it sooner. There may be no inherent advantage on one part, or disadvantage on the other, but only a present superiority of acquired skill and experience. A protecting duty, continued for a reasonable time, may permit the country which lacks this skill and experience to carry on the industry until the producers are educated up to the level of those with whom its processes are traditional." Comment on this argument for the protective tariff.
13. "We are importing at the rate of about $300,000,000 worth of foreign goods per month into the United States. Most of these goods could be made here. There is not a manufactured article produced in the United States in which the labor cost is less than 90% of the total cost following the raw material from start to finish. Now, if that is true, of the $300,000,000 that we are sending abroad each month to buy foreign-made goods, $250,000,000 is going out from the people of the United States to employ German, French, English, Japanese, and Chinese labor, while our own workers walk the streets in idleness. Unless adequate protection is secured against foreign-

made goods, there is little hope of this country being able to maintain the present standard of living of the American workingman and woman."

Is this a valid argument for the protective tariff? Why?

14. Is the protective tariff effective as an instrument for shielding a country from outside economic influences and for promoting economic stability? Why?
15. Would the efforts of nations to be economically self-sufficient be more or less likely to promote world peace than would the economic cooperation and interdependence of these nations? Why?
16. What is meant by the "scientific tariff"? Explain. Would you favor a tariff law of this kind? Why?
17. "The use of the policy of protectionism by the United States has been particularly unfortunate in recent decades." Explain.
18. Explain fully why it has been so difficult in the past to obtain a general downward revision of our tariff.
19. State the major provisions of the Reciprocal Trade Agreements Act of 1934.
20. "The reciprocal trade agreements program has been condemned as being too effective." Explain.
21. Show why the effects of the reciprocal trade agreements program on our international trade are difficult to measure.
22. Describe the additional governmental controls which were applied to the international trade of the United States during World War II.
23. Did our wartime controls have the effect of sharply reducing the volume of our international trade? Explain.
24. What are the objectives of the International Monetary Fund, and how is the operation of the Fund expected to lead to their attainment?
25. "Rigid adherence to the provisions of the agreement concerning the International Monetary Fund is likely to modify the policy of the United States with regard to international trade." Explain.
26. How is the operation of the International Monetary Fund supposed to make for a larger volume of international trade and the stabilization of international monetary relations? Explain.
27. Discuss the possible significance of the Economic and Social Council of the United Nations and its functions in relation to international trade.

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14. *Foreign Investments and International Indebtedness*

We begin our study of the problems of foreign investments and international indebtedness by examining the general principles on which international loans and investments, and exports and imports of capital are based.

The Economic Effects of a Net Outflow or Inflow of Capital

The Meaning of an "Export of Capital." In considering the process by which international indebtedness is incurred, we should recognize that, in speaking of international movements of capital, the word "capital" is being used in a somewhat different sense from that in which it is ordinarily used by economists. Its usual definition is "produced goods intended for further production"; that is, capital is a part of those scarce, material, and transferable goods that are commonly called "wealth." When borrowing takes place between nations, however, the capital that is imported and exported consists, in the first place at least, of purchasing power or claims upon wealth, rather than articles of wealth themselves.

What happens whenever the individuals or governments of foreign nations obtain loans in the United States—or, to look at it from the other point of view, whenever we make investments in foreign securities or properties—is that purchasing power, such as bank deposits, formerly owned by people in this country is turned over to foreigners or foreign governments. A part of this purchasing power must be spent in the United States for the banking services in connection with the loan, while another part may be spent here if this country appears to be the most advantageous market for the particular commodities desired by the borrowers or if the terms of the loan provide that a certain part is to be spent here. It usually happens, however, that a considerable part of such loans is—for a

time at least—wanted by the borrowers in some other form than commodities and services. Even though, in the last analysis, the borrowers in many cases will want commodities and services, their immediate desire is usually to obtain most of the loan in the currency of their own country, to be used there, or to obtain commodities and services from some country other than the one that extended the credit.

The borrowers' problem, then, becomes that of transferring purchasing power from the lending country to their own country. This may be accomplished by having their agent in the lending country use their credit balances to buy bills of exchange on the borrowing country and send them to the borrowers, or by themselves drawing bills of exchange against their balances in the lending country and selling the bills at home. Conceivably, their balances in the lending country could be used to buy gold there, which could then be transferred to the borrowers.

A Persistent Net Capital Outflow and the Foreign Exchange Market. When a country has a persistent net outflow of capital, the problem of transferring the funds becomes serious. The borrowers' attempts to convert the funds by buying bills of exchange in the lending country add to the already existing demand for drafts on the borrowing country or on other countries not directly involved in the lending. On the other hand, their attempts to transfer funds by selling at home bills of exchange on the lending country add to the supply of such exchange already existing in the borrowing country. Since the increased demand in the lending country for exchange on the borrowing country, and the increased supply in the borrowing country of exchange on the lending country, would persist because of the continuing loans, the effect would be to raise in the lending country the exchange rate on the borrowing country and lower in the borrowing country the exchange rate on the lending country. These changes in exchange rates seem likely to result ultimately in a flow of gold from the lending to the borrowing country, although other conditions may intervene to render this flow unnecessary during a greater or lesser period of time.

For example, it is probable that dealers in foreign exchange in the lending country can set up credit balances in the borrowing country through short-term advances by the banks there, and can sell additional exchange on the borrowing country by drawing bills against these balances. It is also entirely possible that the central

bank of the borrowing country may intervene and offer to give the borrowers funds in the borrowing country in exchange for the claims against credit balances held by the borrowers in the lending country. The purpose in doing this, from the central bank's point of view, may be to prevent an inflow of gold when such a flow appears undesirable because of conditions either in the borrowing country or in the international credit situation, or to obtain foreign exchange which may be counted as a part of legal banking reserves in some countries. Either type of banking activity, however, will be indulged in only so long as it appears desirable with regard to banking, reserve, and gold conditions at home and abroad; and when these activities cease, a flow of gold tends to take place.

The Effect on International Trade. If the flow of gold toward the borrowing country, because of a persistent capital movement, is so large and so long-continued that the lending country's credit base is reduced and the quantities of money and deposit currency in use are curtailed, there tends to be a decline in the general price level. On the other hand, the price level in the borrowing country tends to rise under the influence of the increases in money and deposit currency that have resulted from the borrowing process. So far as the fall in prices in the lending country makes its goods appear cheap to other countries, it becomes a good place in which to buy and its exports become large in relation to its imports, since the commodities of other countries seem expensive as compared with the goods obtainable at low prices at home. On the other hand, the borrowing country, with its high prices, becomes a highly desirable market, while it is able to sell only comparatively small quantities of its commodities and services in other countries. As a result of this situation, the borrowing country comes to have an "unfavorable" balance of trade, while the lending country has an export surplus.

However, it is known that even substantial transfers of gold between countries do not necessarily alter their respective price levels. But whether the price levels change or not, the results may be much the same, for there is likely to be, in any case, an expansion of purchasing power in the borrowing country. The expansion may be extensive, since the country's banking reserves are increased by the inflow of gold, or by the acquisition of foreign exchange which is counted as reserves in some countries. The increase in the monetary demand for economic goods in the borrowing country is likely to stimulate production (and speculation), but a part of the purchas-

ing power is likely to be used for importing products from other countries. Moreover, some part at least is likely to have the effect of increasing the exports of the lending country, either directly, or indirectly by way of another country or countries.

Qualifications and Conclusions. This description of the effects of a persistent net outflow of capital from a particular country has been presented as simply as possible. Page after page of qualifications have been written on the theory described here. These qualifications concern such questions as the differences between domestic, import, and export prices when the general price level is rising or falling, the effects of lending upon countries not directly involved, and the influence upon trade relationships of such economic phenomena as dumping, international cartels, and tariffs and other obstacles to trade. The conclusion to be drawn from the discussion is that, when a country is experiencing a persistent net outflow of capital, its exports of commodities, services, and gold tend to be large as compared with its imports, while the reverse is true of the borrowing country. This import-export relationship in the lending country may come about through an increase in exports while imports are unchanged, by a decrease in imports while exports remain constant, or by a change in both.

A Persistent Net Inflow of Payments on Account of Long-Term Indebtedness. International loans, however widely some may appear to differ from others, are all alike in one respect, in that they make it necessary for payments to pass from the borrowing to the lending country on account of interest or dividends, and eventually in the repayment of principal. The longer a country has had a persistent net outflow of capital funds, the greater are the sums it must receive annually, and the more difficult will it be for the country to keep on lending enough to make the net flow of payments on the capital account move outward. Eventually the time comes when, from the standpoint of the lending country, the inward payments on account of existing indebtedness, added to the payments representing new investments of foreigners in the lending country, will exceed the exports of capital being made by the lending country, and the net balance of payments on account of long-term indebtedness will be inward and not outward.

When this happens we may expect the same sequence of events as has already been described, except that the country which is being repaid will be in the position formerly occupied by the bor-

rowing country. The need to transfer net payments to the former lending country operates to increase both the demand for foreign exchange in the repaying country and the supply of exchange on the repaying country in the one that is being repaid. The rate of exchange on the creditor country rises, while that on the debtor falls. Eventually, after the banks in each country have gone as far as appears wise in facilitating the transfer of funds, a flow of gold to the former lending country may be expected. Despite all steps that can be taken by the central banking system of the creditor country, some expansion of its purchasing power—that is, an expansion of its money and deposit currency as compared with that of the debtor country—may be expected. This relative change in purchasing power will, as before, influence imports and exports, tending, directly or indirectly, to increase imports to the former lending country and to increase exports from the debtor country, regardless of whether or not the price level rises in the creditor country and falls in the debtor country.

In ending this description, we may refer once more to the qualifications of this broad statement of theory which it might be desirable to present were this discussion more extended. Our conclusion is, nevertheless, that a country that is receiving a persistent net inflow of payments on account of long-term indebtedness will have an "unfavorable" balance of trade—that is, an excess of imports—and that repaying countries will tend to be affected in the opposite manner. This changed relationship of imports to exports in the country that is being repaid may come about through a growth in imports while exports remain constant, through a decline in exports while imports remain constant, or through a change in both; and the same analysis applies to the repaying country. It does not follow that the country that is being repaid will necessarily have an increase in imports from or a decrease in exports to the country that is repaying, or that the latter must have an increase in exports to or a decrease in imports from the country that is being repaid. These things may happen, or they may not. But we know that the country which is receiving net payments *must* have an import balance of trade from whatever source derived, and that the reverse is true for the repaying country.

The United States as a Creditor Nation

The First World War Period. Up to the year 1916 the United States was a debtor nation. At the beginning of World War I, we, as public and private debtors, owed individuals of other countries approximately 5½ billion dollars, while foreign individuals and governments owed individuals in the United States about 2½ billion dollars.[1] Between 1914 and the end of 1919, the United States made huge loans, both public and private, to many countries, and as a result found herself an international creditor to the extent of about 18 billion dollars. This sum, however, represented the nominal value of foreign obligations to this country rather than the actual value, which was probably about 14 billion dollars in view of the adjustments finally made in the war debt obligations of the Allied governments to this country. In addition, allowance should be made for our obligations to other countries, amounting roughly to 4 billion dollars; so that the net actual indebtedness of individuals and governments throughout the rest of the world to individuals in, and the government of, the United States at the close of 1919 was almost 10 billion dollars.[2]

The 1919–30 Period. The growth of the United States as an international creditor did not end in 1919. While our government ceased to lend to other governments a few years after the close of the war, the private investments of our people in foreign securities and properties continued at a merry pace until, by the end of 1930, it was estimated that the total indebtedness of foreign governments and individuals to the United States government and individuals in this country amounted roughly to 22 billion dollars.[3] This figure, however, did not include our investments in Alaska, Hawaii, and Puerto Rico, or in missionary and educational institutions abroad, or any *short-term* obligations due individuals in this country. If we deduct from this estimate some 4 billion dollars, which was approximately our indebtedness to foreign countries in all but short-term obligations, there remained a net indebtedness to the United States of about 18 billion dollars.

[1] R. A. Young, *The International Financial Position of the United States,* New York, National Industrial Conference Board, Inc., 1929, p. 3.

[2] *Ibid.,* pp. 48, 49.

[3] United States Department of Commerce, Bureau of Foreign and Domestic Commerce, *A New Estimate of American Investments Abroad,* Washington, Government Printing Office, 1931, pp. 1, 2.

The War Debts. The fact that the United States was so great an international creditor in 1930 caused considerable concern, especially in view of the traditional high tariff policy of this country. One of the most disturbing elements in the situation was the matter of the war debts. After the United States entered World War I in April, 1917, loans to the Allied countries consisted largely of direct advances from our government to their governments, as authorized by the various Liberty Loan Acts. It was these direct intergovernmental loans that resulted in the war debts. In making these loans, funds held by individuals and organizations in this country were turned over to the United States government through the purchase of Liberty Bonds. This government then placed the funds, or credits, at the disposal of the Allied powers as needed for the purchase of materials and supplies, the stabilization of foreign exchange rates, and for other purposes.

The war loans, which resulted in the war debts, differed from ordinary international loans in at least two important respects. As we have already noted, these loans were made by our government directly to the governments of the countries with which we were allied, whereas foreign loans are ordinarily made by individuals or companies in one country to individuals or companies in other countries. Hence, the war debts constituted a political as well as an economic problem in all the countries involved. In the second place, the proceeds of the war loans were used for purposes of destruction, so that their expenditure did not provide the means of repayment by adding to the productive capacity of the borrowers. Ordinary loans, of course, are made primarily for productive purposes.

The Funding Agreements and War Debt Statistics. Several years elapsed after World War I before arrangements were made for repaying the war loans. The first "funding" agreement, or arrangement for payment by installments over a long period of years, was concluded with Great Britain in 1923. Other funding agreements followed, until by 1927 the largest debtors of the United States had made arrangements to settle their war debts. The total nominal funded indebtedness of our debtors on account of war loans proper, purchases of surplus war supplies, purchases from the United States Grain Corporation, and relief credits, was 11,468 million dollars in November, 1928. To clear up this indebtedness, the debtor nations were obligated to pay some 20,938 million dollars, on account of principal and interest, between 1929 and the

end of the debt-paying period, about 1987. The value of these scheduled payments, as of 1929, was 7870 million dollars, with the future payments discounted at 4 per cent, or 6538 million dollars at the rate of 5 per cent.[4]

Prospects for War Debt Payments. Even after the war debts were safely funded and future payments arranged, there was considerable doubt that these debts would ever be paid. Several factors led to this doubt. First was the question whether the debtor nations were economically able to make the required payments, and whether those in power in these nations would find it politically safe to undertake the payments. Second was the question whether the debtor nations were under moral obligation to pay. The debts had been contracted after our entrance into the war—after the war had become our cause as much as that of the debtor countries. Many of these nations thought that our advances to them should have been regarded not as loans to countries pursuing an objective in which we took no interest, but as expenditures for the security and defense of the United States quite as much as for that of any of the Allied countries—in other words, that they were contributions, according to our ability, to a common cause.

In the third place, the willingness of some countries to make the war debt payments was affected by the discrimination we had practiced in making the war debt settlements, for we treated some of our debtors much better than others. Fourth, it was apparent that the governments of the debtor countries could not, as a matter of political expediency, tax their citizens in order to make war debt payments to the United States unless they continued to receive their reparations payments. By "reparations" we mean those payments which Germany was obligated to make her opponents in World War I for loss and damage to which the Allied and associated governments and their citizens had been subjected by Germany. There was great doubt that Germany could make the payments which had been imposed on her, but little question that our debtors would refuse to pay us if they did not receive their reparations.

Finally came the important question whether the United States could receive the war debt payments. Some people insisted that there would be little difficulty in this connection, because of the relatively small size of the annual payments. While 256 million

[4] R. A. Young, *The International Financial Position of the United States,* pp. 192–193.

dollars per year, the annual average payment due from 1930 to 1934, is a large absolute amount, it is only a fraction of one per cent of the annual income of this country in good years and bad, and less than 6 per cent of our imports in 1929. But the war debt payments could not be considered by themselves, for we would have had to receive these payments in addition to all other payments which had to pass from other countries to this country year by year. In 1930, our private foreign investments amounted to about 15 billion dollars. A yield of 5 per cent on these investments would have required the acceptance of about 750 million dollars a year by this country, if investors were to receive interest payments and dividends.

These incoming payments would have been offset to some extent by outgoing payments on account of the investments of foreign countries in the United States. However, the total payments to be received from abroad in each year would have amounted to a large figure. These incoming payments count as exports in our balance sheet of international payments. That is, they bring about a situation like that which results from a heavy exportation of a commodity (say, wheat), which would also require foreigners to make payments to this country. Therefore, if we were to receive these payments on account of foreign indebtedness, our total imports of commodities and services would have had to exceed our other export items (which required payments to us) by the amount of the war debt payment and investment payments to us. It would have been necessary, in other words, for us to have received a heavy surplus of imports, apart from the war debt payments.

Under other conditions it might have been possible for us to achieve this necessary import balance of trade, but in 1930 our high protective tariff made it practically impossible to accept the necessary imports. Moreover, generally high tariffs and other obstacles to trade throughout the world made it difficult at that time for the debtor countries to export enough to set up the necessary balances abroad, against which bills of exchange could be drawn to make payments to us. It appears, therefore, that our policy with respect to international trade was inconsistent with our position as an outstanding creditor nation, and threatened to destroy the value of our public and private loans and investments abroad. But, it may be asked, could not the United States have achieved the import balance of trade essential to the payment of foreign debts without lowering

the tariff and increasing the importation of dutiable articles? It is true, of course, that an import balance of trade might have been obtained by reducing exports, as well as by increasing imports, but it is difficult to believe that this alternative would have been popular with the rank and file of American business men. If it had been possible to increase greatly our net imports of services, this country might have received large net payments on account of long-term indebtedness without much change in commodity imports. However, it did not appear that any great or sudden expansion in these service items could be looked for at that time. Certain "invisible items," such as tourists' expenditures, might have been expected to increase as time went on. Other items, such as the remittances of immigrants and payments for freight services, were more likely to decrease, the first because of our immigration policy, and the second because of agitation for the development of an American merchant marine. All in all, no great amount of relief could have been expected from this quarter.

Payments to the United States Before 1930. But, it may be asked, were not war debt and reparations payments made and received in the years before 1930, and did not the United States in those years also receive large payments from abroad on her private loans and investments? The answer is really negative in both cases. Between 1924 and 1930, Germany paid reparations to the amount of 10,300 million Reichsmarks. In order to do this, we might assume on general principles that she had an export surplus of about the same amount, and thus acquired the necessary foreign balances against which the reparations payments were drawn. Actually Germany had in this period an *import* trade balance amounting to 6300 million Reichsmarks. The large reparations payments were possible in the face of this import trade balance only because, in the same period, Germany had borrowed 18,000 million Reichsmarks.[5] These loans came, to a considerable extent, from the United States. Thus, through borrowing abroad, Germany acquired the foreign balances with which to make reparations payments to the Allies. When these balances came to the Allied nations, they were able to make war debt payments to the United States, despite their inability to export to us, and our inability or unwillingness to import from them to any great extent. The reparations and war debt payments in these years

[5] *The Economist*, London, England, Supplement on the War Debts, November 12, 1932.

amounted fundamentally to our taking large quantities of funds from one pocket and returning smaller quantities to another pocket.

To determine whether the United States actually received large annual payments on account of private loans and investments abroad, in the years before 1930, it is necessary to consider all of the several items that result in payments into or out of this country, on account of long-term indebtedness. Among the outgoing items there are payments on account of imports of securities (both new issues and those outstanding), investments of Americans in foreign properties, government advances to foreign governments, and redemption and sinking fund payments and interest and dividends on our securities held abroad. Among the incoming payments are included those on account of outstanding securities exported, investments of foreigners in properties in the United States, the principal of our government advances and credits returned, interest and dividends on our private investments, interest on our government advances, and the redemption and sinking fund requirements of foreign securities held by us.

When the incoming annual payments are compared with the outgoing payments on the long-term capital account from 1919 to 1930, a fairly good balance of the two movements of funds is observed. For a few years after 1919, there was a net outflow of payments from the United States, but somewhat later there developed a tendency for incoming payments to be slightly in excess of outgoing payments. On the whole, then, there was no real net inflow of payments on our foreign loans and investments in this period. Instead, we maintained and increased the net indebtedness of other nations to us by, in effect, *reinvesting* the amounts due us on account of interest, dividends, and the repayment of principal. Individuals in the United States, of course, received such payments when due, but we as a people refused them, or at least canceled their effects, by making every year a net balance of new foreign investments and loans of substantially the same amount as we received on account of old loans and investments. All in all, the creditor position of the United States did not appear very secure as of 1930.

The Elimination of the War Debts. In the decade after 1930, the creditor position of the United States virtually disappeared. The first step in the process was the complete loss of the value formerly attributed to the war debts—7 billion dollars as of 1930. When the depression of 1929 came and Germany's foreign sources of credit

dried up almost overnight, she was in a serious position, for her heavy borrowings obligated her to make large annual payments on her private foreign debts, in addition to her reparations payments. Confronted by the depression and by high tariffs and other obstacles to trade which other countries were maintaining, Germany could not expand her exports sufficiently to acquire foreign balances for purposes of debt payment; nor could she provide the necessary export balance of trade by reducing her imports.

By 1931, it appeared likely that Germany, if left to her own devices, would have to default on her private debt payments to other countries, and on reparations payments as well. This would have meant loss to many private investors in the United States, and the non-payment of war debts by our former Allies because of Germany's failure to pay reparations. Acting on the principle that half a loaf is better than no bread, President Hoover proposed that, for one year dating from June, 1931, all war debt and reparations payments should be suspended. The other nations concerned eventually agreed to this proposal. In this way, a default on private debt payments due American citizens was temporarily avoided.

In the summer of 1932, the Lausanne Agreement gave Germany permanent relief from her reparations obligations, although this abandonment of reparations was presumably contingent upon a like action by the United States with respect to the war debts. Actually it meant the end of reparations, despite the fact that this country took no official action on the war debts. Nevertheless, Germany eventually defaulted on her private debt payments to other countries, by a series of steps taken in 1933 and 1934. After the abandonment of reparations, the countries which owed us war debts, with the single exception of Finland, persistently refused to meet these obligations and there is no longer any hope that these debts will ever be paid.

Decline in the Value of Our Private Investments Abroad. The private investments of American individuals and firms in foreign countries, which were estimated at 15 to 15½ billion dollars in 1930, amounted to some 13 billion dollars at the beginning of 1935.[6] But this latter figure does not show the true extent of the decline which had taken place in the value of our private investments abroad. These investments are divided into direct investments and portfolio

[6] *Barron's Financial Weekly*, September 16, 1935, pp. 5, 6.

(or security) investments. Direct investments are those which involve direct participation in commercial and industrial enterprises abroad, such as investments in American-controlled manufacturing and distributing organizations, mining properties, petroleum lands, plantations, and other properties. The portfolio investments include all our holdings of foreign securities, either publicly offered in this country or secured through purchase in the international market. The direct investments of almost 8 billion dollars at the beginning of 1935 represented the book value of these investments as reported by their owners at the end of 1929 with allowances for additions and deductions since that time, and the figure of over 5 billion dollars for portfolio investments represented the par value of the securities.

While the estimate of direct investments allowed for changes in the quantity of these investments, it apparently did not allow for changes in their value, which must have declined appreciably by 1935 as a result of the depression. However, when the depreciated foreign values of these properties were converted into depreciated United States dollars, it is quite possible that the estimate given for these investments was about right. But this conclusion can scarcely apply to the portfolio investments. Since most of these securities were already expressed in terms of dollars, they could not benefit by conversion into devalued dollars; and the actual value of the securities was probably much less than their par value by 1935, because of total or partial defaults by the debtors on many of the securities.

The creditor position of the United States deteriorated rapidly after 1935 as the result of a large flow of capital funds to this country. This movement had its origin in a number of economic and political factors in the United States and elsewhere. In 1936 and 1937, improved business conditions in the United States led citizens of foreign countries to invest in American stocks and bonds. Disturbed economic and political conditions in France after 1935 resulted in a flight of capital funds from that country, and a large part of these funds came to the United States. The devaluation of the belga in 1935 and of the franc in 1936, together with other difficulties of the gold-bloc countries, was accompanied by a movement of short-term funds to the United States. Other large quantities of short-term funds moved here as a result of the European political and war crises of 1938 and 1939.

The statistics of the period from January, 1935, to September, 1939, indicate that American banks and brokers reduced their funds

held in foreign countries from $1,234,000,000 to $532,000,000. On the other hand, the funds held by American banks and brokers for foreign customers increased from $679,000,000 to $3,195,000,000. Foreign holdings of stocks and bonds of the United States increased from $2,089,000,000 to $3,200,000,000, while American holdings of foreign dollar bonds were reduced from $5,296,000,000 to $3,950,-000,000. Since it required a flow of only $677,000,000 to the United States to reduce our holdings of foreign bonds by $1,346,000,000, it is clear that these securities were disposed of at prices which averaged about 50 per cent of par. In September, 1939, foreign-owned direct investments in the United States amounted to $2,435,000,000, and direct American investments in foreign lands totaled $7,100,-000,000.

The net creditor balance of the United States was changed by these developments so that, by September, 1939, it amounted to only $2,752,000,000. At that time, the long-term investments of the United States in foreign countries amounted to $11,050,000,000, while our short-term investments abroad totaled $532,000,000. On the other side of the ledger, foreign long-term investments in the United States were $5,635,000,000, and short-term foreign investments here were $3,195,000,000.[7] The movement of capital funds into the United States continued throughout the remainder of 1939, and in 1940 there was an additional net movement of some $2,500,-000,000 into this country.[8] Hence, as of the beginning of 1941, our short- and long-term obligations to other countries just about equaled their short- and long-term obligations to us.

The Present and Future Position of the United States

The Present International Financial Position of the United States. World War II, unlike its predecessor, did not result in a great extension of the position of the United States as a creditor nation. As in World War I, our Allies asked for large advances of food, munitions, services, and many other things; and we furnished economic goods worth about 38 billion dollars, as we noted in the preceding chapter. However, in World War II these deliveries to our Allies were made on the basis of the Act to Promote the Defense of the

[7] The statistics for the 1935–39 period are from A. Maffry and P. D. Dickens, "The Balance of International Payments of the United States in 1939," reprinted from the *Survey of Current Business*, February, 1940.

[8] *Survey of Current Business*, February, 1941, p. 55.

United States, passed in March, 1941, which (as we have already noted) authorized the President to sell, transfer title to, lease, lend, or otherwise dispose of various defense goods to other countries whose defense was deemed vital to that of the United States. The lend-lease deliveries were not construed by this country as loans, and did not result in debts of other nations to the United States, for the Act provided that the offsetting benefit to the United States could be payment in kind or property, or any other direct or indirect benefit which the President deemed satisfactory.

With lend-lease deliveries to our Allies and foreign loans by our federal government eliminated from the analysis, the United States became a debtor nation again before the end of World War II. Late in 1944 our total investments abroad amounted to 11.1 billion dollars, while foreign investments in the United States totaled 12.3 billions, leaving us a net debtor by 1.2 billions. Our long-term investments abroad still exceeded long-term foreign investments in the United States by 4.4 billion dollars, but we had only one-half billion dollars' worth of short-term investments abroad, whereas foreign short-term investments in the United States came to 6.1 billion dollars.[9]

Prospects for Increased Foreign Investments. After the end of the war, however, there seemed to be an excellent chance that the United States would soon become a large-scale creditor nation once more. Several factors gave support to this conclusion. For one thing, short-term foreign investments in this country had been made for the most part with funds sent here for safekeeping, and it was considered probable that a large portion of them would be withdrawn after the return of peacetime conditions. Second, the end of the war and the discontinuance of lend-lease deliveries to our Allies found large quantities of American goods in transit, or actually in foreign countries but not yet delivered. Since lend-lease deliveries were no longer possible, these goods were in many cases sold to our Allies on credit. Third, soon after the end of the war the government of Great Britain applied to the government of the United States for a loan of $3,750,000,000, and it was rather expected that the governments of other countries would make similar applications. Finally, the foundation of the International Bank for Reconstruction and Development seemed to open up a wide field for foreign investments on the part

[9] National Industrial Conference Board, *The Economic Almanac for 1945–46*, New York, 1945, p. 306.

of the United States. The latter two matters warrant further comment.

The Loan to Britain. As agreed upon by the two governments, and ratified by the British Parliament and the Congress of the United States, the loan to Britain involved $3,750,000,000 of "new" capital. The British obligation to repay, however, amounted to $4,400,000,000 exclusive of interest, with the extra $650,000,000 constituting the sole return to the United States for some 27½ billion dollars' worth of lend-lease deliveries made to the British Empire during World War II. The loan was to be spent largely in the United States for machinery, raw materials, food, and other commodities and services. Repayment was scheduled to be made in fifty installments, beginning December 31, 1951, and with interest at 2 per cent from that date on.

Great Britain was said to need the loan because the war had greatly reduced her ability to pay for needed imports. Her export trade had been seriously curtailed, she had been forced to sell part of her foreign investments, and many of her ships had been sunk by enemy action. The loan was expected to tide her over the period necessary for rebuilding her foreign trade, and to restore her ability to perform the services she formerly rendered to other countries. It was argued that, if Great Britain were unable to secure this loan from us, she would be compelled to continue and increase the use of restrictive measures and devices, such as high tariffs, preferential tariff agreements within the empire, the sterling bloc, exclusive bilateral trading arrangements, private international cartels, quotas, export and import licensing, and exchange controls. Such a policy on the part of Great Britain would go far toward defeating international plans for the stimulation of trade and the stabilization of monetary and exchange relationships between countries.

Besides agreeing to repay the loan with interest, Great Britain promised to enter into negotiations for the reduction or elimination of various trade barriers, such as those mentioned in the preceding paragraph, and to participate in an International Conference on Trade and Employment which, it was hoped, would reach an agreement on an international code covering trade barriers, restrictions, and discriminations, and would blueprint an International Trade Organization that would work in close relation with the Economic and Social Council of the United Nations. More specifically, Great Britain agreed that, if the loan were made, she would not restrict

payments to the United States for export or other current transactions, she would end most exchange controls within a year, and she would discontinue the use of import quotas in a way that would discriminate against American traders, save under specified exceptional circumstances, by the end of 1946 or earlier.

The loan to Britain was not altogether popular in the United States, despite a strenuous propaganda effort in its behalf by our government. The benefits of the loan to Great Britain were deemed immediate and substantial, while the resultant gains to the United States were considered to be vague, indefinite, and deferred, though potentially important. Though the terms of the loan were considered harsh by many British citizens, they appeared excessively mild to some people in the United States. There was some doubt that the loan was a sound credit transaction, or that it would have been seriously considered by any agency except our federal government. The payments of principal and interest were spread over such a long period of time and were hedged about with so many restrictions and qualifications that many people doubted that they would ever be made. Hence, it was held, the loan should be considered and evaluated as an outright gift. In view of our past experience, it was perhaps understandable that some of our citizens should be a bit cynical about a loan made by the federal government to the government of another country.

The International Bank for Reconstruction and Development. The Bretton Woods Agreement, as ratified by thirty-eight countries up to April, 1946, provided for the International Bank for Reconstruction and Development as well as for the International Monetary Fund. The Bank will have a total capital of 9.1 billion dollars. The United States will make the largest subscription to this capital ($3,175,000,000), followed by the United Kingdom, Russia, China, France, and other member countries. Ten per cent of each country's subscription will be paid in, 10 per cent will be subject to call, and the other 80 per cent will be held in reserve in the member country to be called for only when it is required for the purpose of covering losses sustained by the Bank.

The Bank is to be controlled and managed by a Board of Governors, Executive Directors, a President, and other necessary officers and staff. Each member country will appoint one Governor to the Board, and the voting power of the individual Governors will be determined in the same way as in the case of the International Mone-

tary Fund. There will be twelve Executive Directors, who will serve two-year terms. Five of these Directors will be chosen by the five countries that make the largest contributions to the capital of the Bank, and the other seven by the other member countries. The President of the Bank is the equivalent of the Managing Director of the International Monetary Fund, and he will have an Advisory Council of seven members chosen by the Board of Governors to represent banking, commercial, industrial, labor, and agricultural interests.

The stated objectives of the Bank are: (1) to assist in the reconstruction and development of the territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peacetime needs, and the encouragement of the development of productive facilities and resources in the less developed countries; (2) to promote private foreign investment by means of the guarantee of or participation in loans and other investments made by private investors and, when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, funds out of its own resources; (3) to promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment; (4) to arrange the loans made and guaranteed by it in relation to international loans made through other channels so that the more urgent and useful projects will be dealt with first; and (5) to conduct its operations with due regard for the effects of international investment on business conditions in the territories of member countries and, in the immediate post-war years, to assist in bringing about a smooth transition from a wartime to peacetime economy.

As some of these statements suggest, the Bank may make or facilitate international loans in three ways. First, it may make direct loans out of its own funds, using the 20 per cent of its capital actually paid in by or on immediate call from the member countries. Second, the Bank, with the approval of the member countries in whose financial markets the funds are raised, may borrow funds which can then be converted into other currencies or into gold and used for direct loans. In providing foreign exchange for a borrower, the Bank must give him the particular currencies which he requires. It will not give him dollars unless he needs dollars to spend in the United States.

On the other hand, a borrower cannot acquire currencies from the bank for the purpose of selling them in the exchange markets for other currencies.

The Bank determines the interest rate, the amortization payments, the maturity, and the commission to be charged, in connection with direct loans of either type. The charges and the repayment schedule must be reasonable and appropriate to the projects financed. Repayments of principal and payments of interest and commission must be made in currency of the borrowers which has a value equivalent to the dollar value assigned to these payments when the loans were made. Third, international loans may be made by private investors and agencies through the usual investment channels and be guaranteed by the Bank. Loans of this type must meet conditions similar to those prescribed for direct loans. The Bank must receive suitable compensation for its risks in guaranteeing loans. For the first ten years the commission charged on such loans must be between 1 and 1½ per cent, but it may be lowered thereafter. All payments of commission received by the Bank must be kept as a reserve.

If the Bank functions according to schedule, its operation will tend to push the United States to the forefront as a creditor nation. Clearly the Bank could not function extensively in the field of international loans and investments with 20 per cent of its own capital. Equally clearly, no country except the United States will be in a position to do much international lending for years to come. If the Bank is to raise funds in the markets of a member country in order to make direct loans to other countries, the country supplying the funds is almost certain to be the United States. Similarly, the international loans made by private investors and guaranteed by the Bank are almost certain to originate in the United States.

Our Future Policy. The problem of the moment is whether the United States should once more become a creditor nation on a large scale, and if so, to what extent. Certainly there is little in our experience in the field of foreign loans and investments to commend such a policy. Our past mistakes in making foreign loans and investments are fairly obvious. We have bought risky, high-interest foreign bonds from issuing governments already overburdened with public and private obligations to other countries. We have bought the bonds of countries which were notorious as graveyards for foreign investments and as defaulters on their obligations. In short, we have loaned to foreign governments when we would never, as

private business men, have extended credit to prospective borrowers under similar conditions. We have been willing to purchase the securities of foreign companies with high-sounding names without any knowledge of their financial condition, present business, and future prospects. Undoubtedly, there is a certain glamour about a foreign investment, but glamour scarcely compensates the investor for the loss of principal or interest, or both. Even our direct investments abroad have sometimes indicated poor judgment, if nothing worse.

On the other hand, despite the mistakes of the past, there are legitimate and valuable functions to be performed by foreign loans and investments. They aid in the development of new countries and backward areas. Thus they facilitate the extension of international specialization, or division of labor, and make for an increase in world production, markets, and trade. Foreign investments also contribute to the maintenance of a sound international financial system based on the gold standard or some other mechanism such as the International Monetary Fund. They help to smooth out temporary disequilibriums of imports and exports, to distribute the world's gold supply among the nations, and to stabilize foreign exchange rates. They are, or might well be, a tie binding the nations of the world together. Finally, they will be badly needed in the post-war period to help devastated and war-torn countries to rebuild and get on their feet once more.

The successful functioning of the various international organizations which have been set up recently would go far toward making foreign loans and investments both safe and profitable for the United States. It would be most unwise and unsafe for us to make large new loans and investments abroad while maintaining our old high tariff policy. If we did this, the new loans and investments would for a time make it possible for this country to export heavily while importing lightly. Eventually, however, the annual payments to be received on account of old loans and investments would exceed, by a large sum, our new annual loans and investments, and the safety of our creditor position would be gravely endangered under the high tariff policy. We should not become a great international creditor unless we are willing to accept the responsibilities of a mature creditor nation. Fortunately, however, the International Monetary Fund, the Economic and Social Council of the United Nations, and the proposed International Trade Organization are all expected to work for the lowering or elimination of tariffs and other obstacles to in-

ternational trade; and the United States, in common with other nations, will have to trade more freely than formerly in order to live up to her responsibilities in connection with these organizations.

Again, large foreign loans and investments would be unwise and unsafe if international monetary relationships and foreign exchange rates remain as unstable in the future as they were during the 1930's. Foreign investments should not be made unless our prospective investors can know, with a fair degree of certainty, at what rate the earnings of foreign properties can be converted into dollars, and what the dollars will be worth when they get them; and until they are assured, further, that some foreign dictator will not destroy the value of their investments by taking over the direct control of properties or forbidding the payment of interest on foreign-owned bonds. Moreover, if we felt that international economic conditions made it imperative for the United States to continue to use a managed currency, so that the dollar had no fixed value in terms of foreign currencies though it might have a fairly stable purchasing power at home, the prospects of our making large new foreign loans and investments would be anything but bright. Here again, however, we should recall that it is one of the major objectives of the International Monetary Fund to stabilize monetary systems and foreign exchange rates and to eliminate managed monetary systems, currency depreciation, foreign exchange controls, and other devices which contributed to the unsatisfactory conditions of the 1930's.

Finally, large foreign loans and investments on the part of the United States would be unwise and unsafe on the basis of our former foreign investment judgment and standards. Our investors have needed to learn that a pooı investment is not sound merely because it is made outside the United States. And they have needed to understand that foreign investment is always risky and that, in appraising prospective foreign investments, they should apply standards which are even more severe and rigid than those applied to domestic investments. The new international organizations may help in this connection also. The International Bank for Reconstruction and Development is intended to operate conservatively. The Bank and the Fund will have adequate information on the member countries in connection with such things as holdings of gold and foreign exchange, gold production, imports and exports, prices, and production. On the basis of such information, it should be possible to estimate a country's credit needs and evaluate its status as a credit

risk more accurately than in the past. We should be able to avoid the overlending to particular countries in which we have indulged on former occasions. And private investors and banks in this country, in turning funds over to the International Bank for the making of direct loans or in purchasing securities guaranteed by the Bank, may be much safer than they were in the past when they had to rely largely on their own judgment and information in making foreign loans and investments.

Thus, the success of the United States as a creditor nation in the post-war period seems to depend on the functioning of the international organizations to which this country has become a party. If these organizations operate well, the United States may have a long and profitable career in the field of foreign loans and investments. If not, the outlook is anything but promising. Some people fear that the International Bank itself may operate to the disadvantage of the United States. Since the United States will be the only important lending country for some time to come and since the other member countries will have a great majority of the voting power, it is said that we shall have here a bank controlled by its borrowers—which, it is claimed, is like having an insane asylum controlled by its inmates. That is to say, it is feared that the Bank, as controlled by the borrower nations, may use our funds to make unsound loans on inadequate security. If this fear actually became a reality, we should find ourselves once more a sadder but wiser ex-creditor nation after a few years.

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1. What is meant by an "export of capital"?
2. How does a persistent net outflow of capital affect the foreign exchange market? How does it affect international trade?
3. What are the economic effects of a persistent net inflow of payments on the long-term capital account?
4. In what respect did the international financial position of the United States change between 1914 and 1919? Between 1919 and 1930? Explain.
5. How were World War I debts created?
6. "The war debts to the United States differed from other international debts in some respects." Do you agree? If so, why?
7. Describe the war debt funding agreements.
8. Did it seem likely, as of 1930, that the war debts would be paid? Explain.
9. Could the United States have received the war debt payments under a continuation of her traditional tariff policy? Explain.

10. Show how the necessity of receiving large annual payments on account of private loans and investments abroad complicated the problem of receiving the war debt payments, for the United States.
11. "The fact that war debt and reparations payments were made and received, prior to 1930, indicates that they could have been made and received after that date." Do you agree? Explain.
12. Explain carefully the significance of the private foreign loans and investments made by the United States between 1919 and 1930.
13. What happened to the war debts after 1930, and why?
14. "In the decade after 1930, the creditor position of the United States virtually disappeared." Explain.
15. Distinguish between "direct" and "portfolio" investments.
16. Why did the actual value of the private foreign loans and investments of the United States decline after 1930?
17. Show how certain developments between 1935 and 1940 affected the creditor position of the United States.
18. Why was there no extension of the creditor position of the United States during World War II?
19. "After the end of World War II, there seemed to be an excellent chance that the United States would soon become a large-scale creditor nation once more." Explain.
20. Indicate the terms and significance of the loan from the United States government to Great Britain.
21. What are the objectives of the International Bank for Reconstruction and Development?
22. How is the International Bank supposed to operate? Explain.
23. "The International Bank may make or facilitate three types of international loans." Explain.
24. Why will the operation of the International Bank tend to push the United States to the forefront as a creditor nation?
25. What grave mistakes have we made in the past in the field of foreign investments?
26. What are the functions of foreign investments? Explain.
27. "The successful functioning of the various international organizations which have been set up recently would go far toward making foreign loans and investments both safe and profitable for the United States." Explain.
28. What should be the post-war policy of the United States with regard to foreign loans and investments? Explain.

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15. The Economic Interdependence of Nations

Many puzzling economic problems have arisen from the fact that population tends to expand while the amount of land—this term including all natural resources—is fixed. Well over a hundred years ago, when Thomas Robert Malthus was formulating his statement of the tendency of population to outrun the means of subsistence, it appeared that the population of Great Britain and other countries had nearly reached the maximum which could be supported. The present population of Great Britain, however, is about four times that which had appeared so large at the beginning of the nineteenth century, and the population of the world as a whole has more than doubled in the same period of time.

Industrialization and Economic Interdependence

In fact, at the very time that Malthus was writing, a movement was under way which was to go far toward affording a solution for the difficulties which he saw and feared, although the solution brought with it new problems, among which is that discussed in the present chapter. The movement referred to was the speedy growth of industrialization, and its early events were so spectacular that it has long been called the Industrial Revolution.

The Case of Great Britain. It is a well-known fact that a country of given size and resources can support a much larger population through industrialization than through agriculture. Great Britain, for example, had great difficulty in providing food for her relatively small population a century or more ago. In recent years, however, she has been able to support many more people on a considerably higher standard of living. This has been accomplished by getting from other parts of the world one-half to two-thirds of her foodstuffs, as well as large quantities of other basic materials, such as

petroleum, copper, lead, wool, cotton, sulphur, aluminum, zinc, rubber, manganese, nickel, chromite, tungsten, potash, phosphates, antimony, tin, mercury, and mica.[1] The chief economic activity of Great Britain, apart from the mining of coal, has been manufacturing. The manufacturing industries have provided enough goods to supply the domestic market and still leave a large surplus to be exported in payment for heavy imports of raw materials and foods.

German Industrialization and Dependence. The industrialization of Germany has developed since the formation of the German Empire in 1871. Since that time, Germany has experienced a growth of more than 50 per cent in population,[2] the concentration of large masses of the people in urban districts, the development of a wide variety of manufacturing industries, a tremendous expansion in foreign trade, and the formation of many large business combinations, or cartels. These changes made it possible for the increased population of the country to enjoy a higher standard of living than prevailed in former years, but this progress was obtained at a cost. That is, Germany in pre-fascist days was dependent upon other countries for a fifth or more of her food, including as much as half her total consumption of fats, and for large quantities of industrial materials as well. She had abundant domestic supplies of coal, nitrates, and potash, and less adequate supplies of iron ore, lead, and zinc, but had to import all or almost all her petroleum, copper, sulphur, aluminum, cotton, wool, rubber, manganese, nickel, chromite, tungsten, phosphates, antimony, tin, mercury, and mica.[3]

The Position of the United States. Economic self-sufficiency on a natural basis is probably as nearly realized in the United States as in any other country, except possibly Soviet Russia, but even this country is dependent upon others for a wide variety of essential products. As the industrialization of the United States has become more complete, the trend in our imports has been more and more toward raw materials and foods and away from manufactured products, while the latter have become an increasing part of our exports, replacing raw and semi-finished goods. The United States can ordinarily produce all the coal, iron ore, petroleum, copper, lead,

[1] P. T. Ellsworth, *International Economics*, New York, The Macmillan Company, 1938, p. 504.

[2] Statements in this introductory section, relating to population and resources, describe the situation which prevailed prior to Germany's attempt to establish a "New Order" in Europe.

[3] P. T. Ellsworth, *International Economics*, p. 504.

sulphur, cotton, zinc, phosphates, and mica she needs; is less well supplied with nitrates, aluminum, wool, and mercury; and must import rubber, manganese, nickel, chromite, tungsten, potash, antimony, tin, and other essential raw materials.[3] We are at least partly dependent upon other countries for tea, spices, coffee, tobacco, wood pulp, hides, silk, jute, hemp, sisal, quinine, and iodine.

The Problem of Economic Interdependence. As we have seen, it has been decided in many countries that the economic welfare of their large and growing populations could best be cared for by placing their chief economic reliance on manufacturing. This has made it necessary for these countries to look to other lands for large quantities of foodstuffs and raw materials for manufacturing, both because no country is suited for producing all essential materials for itself, and because in many of them the soil cannot be made to furnish sufficient food to provide for the needs of the very dense populations. At the same time, markets for large quantities of manufactured products must be found in other countries, so that payments for the incoming foodstuffs and raw materials can be made.

Large-scale production has become the rule in the industrial countries and has made possible the realization of many economies. On the other hand, however, it has required large investments of capital and has brought heavy fixed costs, which make it imperative that the industries be operated continuously and as close to full capacity as possible. This, in turn, has made it necessary that the flow of raw materials be ample and constant, and that markets be ever available in which the products of industry can be sold. The dependence of the nations of the world upon each other for raw materials and markets, and their struggles to obtain and to retain control over these materials and markets, constitute the problem of the economic interdependence of nations.

The Quest for Colonies and Concessions

With several nations undergoing a process of rapid industrialization at one time and realizing more and more keenly the need for foreign markets and importations of raw materials and foods, it is not surprising that these countries cast many a covetous eye at the more backward areas of the world which seemed capable of furnishing markets and materials, and possible homes for surplus populations. However, the needs of the industrial countries were so urgent that these nations declined to leave the development of backward

areas to chance or to a competitive struggle between the rivals. Instead, each country sought to reserve areas for its exclusive colonial development. This does not mean that all colonies have been established because the mother countries needed foods, materials, markets, and relief from population pressure, for many other motives—sentimental, religious, and political—have led to colonization. It may safely be said, however, that these economic needs were a major factor in the struggle for colonies which marked the last few decades before World War I.

Results of the Search for Colonies. As so often happens in economic and other contests, the most advantageous positions in the colonial field were taken by the early comers. The process of industrialization began first and developed most rapidly in England, and it forced an early recognition of the need for outside sources of food and raw materials, as well as for outlets for surplus population and manufactured products. The securing of colonies was considered to be the simplest means of satisfying these wants, and through colonization the British Empire was made to grow by leaps and bounds. It was for many years, if considered as an economic unit, the most nearly self-sufficient political entity in the world. However, for certain purposes, the empire cannot be considered as a unit.

France also got an early start in the race for colonies, but she finished well behind the leader, England, in the quality and quantity of colonies that she finally controlled. Germany and Italy, who started late in the race for colonies, did not secure many rich colonial prizes. Both of these countries obtained colonies, largely in Africa, but they were for the most part areas which were not particularly desirable. Germany, of course, was stripped of her colonies following World War I.

The Economic Development of Colonies. The degree of control exercised over the economic development of the colonies has varied greatly among the mother countries. Some colonies have been left free to develop in their own way, while almost every phase of the economic life of others has been dictated by the nations in control. Quite often the mother country has definitely encouraged the production of essential foodstuffs and materials, or has discouraged the growth of industries which would compete with those already established at home. In any case, colonies have usually been furnished with capital for development through loans or direct investments, and have been aided in building transportation systems and

securing credit facilities. The foreign trade of colonies is often controlled in the interests of the mother countries, which sometimes spend large sums to induce their citizens to emigrate to the colonies. Such inducements may include direct economic incentives to the emigrating people, free maintenance of law and order, and improvements designed to make life in the colonies attractive to prospective colonists.

Preferential Tariffs. The methods by which nations attempt to reap the greatest possible economic benefits from their colonial possessions vary from case to case. One common method is the use of a preferential tariff system. Under such a system, lower duties are applied by the colony to products coming from the mother country than to identical products coming from other sources. Similar discriminations are made by the mother country in favor of the colony. Thus, the industries of the mother country are given the privilege of marketing their goods in the colony upon more favorable terms than those granted to producers in other countries. Whether or not this is a great advantage will depend, however, upon the size of the preferential duties, which may still be sufficiently high to give protection to colonial industries.

While important raw materials are allowed considerable freedom of entrance by most industrial nations, it is often possible for a colony to derive much benefit from preferential duties applied to its products by the mother country. If, for example, the mother country is applying protective duties to certain foodstuffs and raw materials in order to stimulate domestic production, or if it levies high duties on certain foodstuffs for revenue purposes, preferential duties may be a distinct advantage for a colony. Preferential tariffs exist, or have existed, between Spain and her colonies, Portugal and her colonies, France and some of her colonies, and within the British Empire.

Preferential duties, however, are not always on imports. Preferential export duties are often applied to raw materials, and are a menace to amicable trade relations between nations. The purpose of such duties may be in part to encourage shipping and trade, but it is primarily to stimulate industry in the mother country by furnishing it with raw materials on favorable terms. A preferential export duty is simple in application. A certain amount is collected for each unit of the raw material exported, and a part or the whole of this amount is given back if the destination of the export is the mother country, or if it can be shown that the next process in the

utilization of the material will be or has been performed in the mother country or another colony.

One example of a preferential export duty was that of India on untanned hides and skins. In 1919 an export duty of 15 per cent was applied to these articles, and a rebate of two-thirds of this amount was allowed on exports to be tanned within the British Empire. This preferential duty affected American tanners adversely, aroused much resentment, and caused considerable trade to be diverted to other markets. The duty was changed in 1923 so that it affected all countries equally.

As has been said, preferential tariffs are often ineffective because even the preferential rates are so high that little advantage is given to the country that is nominally favored. To the extent that a real benefit is conferred, ill feeling and retaliation by other countries are likely to result. The President of the United States, for example, has had the power to impose additional duties on or even to exclude products coming from any country which discriminates against our commerce.

Assimilated Tariffs. When the tariff policy of the mother country toward the colonies is that of assimilation, discrimination against other countries is complete, for under this policy the colonies are made a part of the mother country for tariff purposes. This means that colonial raw materials, which are subject to an export tax when shipped to other countries, pass to the mother country without interference. At the same time, both colonies and mother country may send goods to each other without fear of import duties, whereas goods from other countries attempting to enter either mother country or colonies run up against the tariff wall of the mother country, within which the colonies are included. The policy of assimilation has been applied by the United States to Puerto Rico, Hawaii, and Alaska, and by France to many of her colonies.

Protectorates. When industrial nations have deemed it impossible or unwise to secure complete control over a backward area through colonization, they have been able at times to accomplish some of their ends through the development of protectorates. A protectorate exists when one state, usually by treaty, gives to another and stronger state a considerable degree of control over its foreign relations, or possibly the right to intervene in its domestic affairs under certain conditions, in return for a guaranty of protection.[4] Pro-

[4] *Encyclopædia of the Social Sciences,* New York, The Macmillan Company, 1934, vol. xii, pp. 567–571.

tectorates have often been set up when an industrial nation has hesitated to take the military action necessary to bring a backward area under complete control or when an attempt at annexation might have aroused the opposition of other industrial powers. Protectorates have, in general, furnished a rather unstable type of control over backward areas, for they have usually become outright colonies in due time or have achieved their independence.

However, they have, in their time, given the protecting nations certain important advantages. The protected countries have often agreed not to conclude any treaties with other countries, obtain any loans from other countries, or make concessions to the citizens of other countries without the consent of the protecting countries. The latter are often allowed to maintain troops in the protected areas, appoint governor-generals, and safeguard the personal and property rights of the citizens of the protected country who are located in other lands.

Mandates. Some control over the development of backward areas has been enjoyed by certain nations under the so-called mandate system. This system developed after World War I under the auspices of the League of Nations. Under a mandate, an advanced state held a backward area in trust for the League of Nations, helping to administer its affairs until it was able to stand by itself. The mandatory state was expected to administer the controlled area for the benefit of the people of that area and not for its own advantage, and to maintain the "open door" policy with respect to other nations. That is, other nations were to be allowed to do business in the mandated territory, to make investments there, and to receive concessions for the development of resources. However, some advantages of an economic character were almost certain to be enjoyed by the mandatory nations from their control over backward areas.

Concessions. Even in the absence of political control, it has often been possible for industrial nations to achieve a measure of control over backward areas by means of concessions. A concession is a grant of power, usually given by a country in which governmental control is weak and which is undeveloped economically, to individuals or companies of other countries to utilize mineral resources or otherwise develop an area, subject to certain rules and restrictions imposed by the granting country. Concessions may be granted for a variety of purposes, but the most important are probably plantation, mineral, and petroleum concessions.

While concessions are not usually made directly between nations, it is nevertheless true that national governments are greatly interested in concessions granted to their nationals. The struggle for the oil reserves of the world has been particularly keen since the importance of petroleum in the operation of naval vessels and airplanes, and in many other uses, has been apparent. Access to adequate oil resources has appeared to be almost a matter of national life or death. A few years ago Great Britain, besides being closely affiliated with the Royal Dutch-Shell oil interests and insisting that the Turkish Petroleum Company's operations should be British-controlled, owned a majority of the shares of the Anglo-Persian Oil Company.[5] This company had a blanket concession which gave it control over the oil resources in all of Persia except five northern provinces. It also owned in part the Burma Oil Company, which was prominent in the Burma field where the British had a monopoly. Concessions for the development of the oil resources of Mesopotamia have changed hands several times. These resources have been exploited by a British-controlled company, with American and French oil companies participating.

The Netherlands has been directly interested in the Royal Dutch-Shell group, which had a virtual monopoly of petroleum production in the fields of the Dutch East Indies, as well as important concessions in South and Central America. While the government of the United States is not so directly interested in American oil companies as are the governments of Great Britain and the Netherlands in their respective companies, it is nevertheless true that our government has been much concerned over the difficulties experienced by American companies in gaining a foothold in the newer oil fields which hold much of the oil supply of the future. Moreover, during World War II, the United States became actively interested in assisting with the development of the oil resources of some South and Central American countries and other areas.

The development of many of the important mineral resources of the world has taken place under concessions. In China, Mexico, and Latin America, concessions have often been granted for the exploitation of minerals by outsiders. The rich resources of Central Africa, which include copper, gold, diamonds, tin, iron, bauxite, and many other minerals, have also been developed under concessions of

[5] C. K. Leith, *World Minerals and World Politics*, New York, McGraw-Hill Book Company, Inc., 1931, pp. 87, 88.

enormous size, held chiefly by companies under the control of Belgian and British capitalists.

Modern Imperialism. The international struggle for raw materials, markets, and outlets for surplus population is not confined to the distant past, for we have recently had a number of modern examples of imperialism. Some countries have been content merely to try to obtain economic control over areas that are economically backward, but others have apparently been ready and willing to conquer, annex, and control politically any areas on which they could lay their hands.

In September, 1931, Japan overran Manchuria and Jehol Province in China, and soon gained control over some 365,000 square miles of territory, much fertile agricultural land, mineral resources, and a population of 30 to 34 million people. Later, the area was set up as a nominally independent state under the title of Manchukuo, but there was no doubt that it had become, in effect, a Japanese province. Again in 1937, and presumably because of an anti-Japanese "incident," Japanese armed forces invaded China and in the next few years conquered large additional sections of the country. According to Japan, her activities in China were purely defensive, but this was clearly an attempt to dress up the wolf of imperialism in sheep's clothing. Finally, in a relatively short time after December 7, 1941, Japan's armed might gave her control over the Philippine Islands, additional areas in China, British Malaya, the Dutch East Indies, French Indo-China, Thailand, and other areas. These adventures brought her, but only temporarily, many millions of square miles of territory, hundreds of millions of people, and many rich sources of vital materials such as rubber, tin, and petroleum.

In October, 1935, Italy undertook to "protect" Italian lives and property from the "barbaric" Ethiopians, and to avenge certain "border outrages" which had allegedly proved humiliating to her national honor. By May, 1936, she had conquered the whole of Ethiopia in "self-defense," and annexed it to Italy. This conquest brought her an area of 350,000 square miles, with a population of 10 millions, and extensive agricultural and mineral resources. A little later, Italy found it necessary, for similar reasons, to conquer neighboring Albania, securing an additional 17,500 square miles of territory and about a million people. These gains, and others acquired later, were stripped from her when she retired most ingloriously from World War II in 1943.

Germany's territorial gains after 1939 were far more impressive than those of Italy. Deprived of her colonies under the Versailles Treaty, and with her vital foreign trade at low ebb, Germany under National Socialism rose in her military might to seize food, raw materials, markets, industrial equipment, and "living room" in general. By actual military conquest or by intimidation, she brought Norway, Denmark, Belgium, the Netherlands, Austria, Czechoslovakia, Hungary, Roumania, Bulgaria, Yugoslavia, Greece, Poland, France, much of Russia, and other areas under her dominion. If Germany could have retained all the regions over which she gained temporary control, her area would have been increased by well over a million square miles, her population by several hundred million people, and her resources by riches that can hardly be estimated. Actually, of course, these gains and more too were lost in the course of World War II, and Germany was visited with a destruction from which she will be a long time recovering.

The Fruits of Imperialism

In general, it is necessary to conclude that the results of imperialism have been rather unsatisfactory. Nations have gained much by industrialization and by drawing upon other parts of the world for food, raw materials, markets, and relief from population pressure, but they have gained relatively little through their attempts to reach these ends by conquest, annexation, and exclusive control. In support of this conclusion, let us examine in turn the advantages which nations are supposed to derive from their colonies or other controlled areas.

Relief from Population Pressure. In many cases, the colonies acquired by industrial nations have served but poorly as outlets for surplus population. As one writer puts it, Italy exhausted herself for many years before World War I to obtain colonies, but when in 1914 the war broke out there were only 8000 Italians in all of her African colonies—a smaller number than lived within a radius of a quarter of a mile of Cherry Street, New York City, and only 2 per cent of the Italian population of the State of New York.[6] He suggested that, if Italy had both control over Ethiopia and freedom of immigration to the United States, 500 Italians would come here annually for every one that went to Ethiopia.

[6] Nathaniel Peffer, "The Fallacy of Conquest," *Harper's Magazine*, January, 1936, pp. 129–136.

Germany's experience was similar, according to this writer. By 1914 she had only 22,000 German colonists in her 900,000 square miles of African colonies, and only 2000 more in all the rest of her colonies. At the time, there were more than 24,000 Germans between 80th and 90th Streets on Manhattan Island, and 25 times as many in New York State. Japan, at a cost of 300,000 men, won South Manchuria from Russia in 1905. Twenty-five years later there were only 200,000 Japanese in this territory, or fewer than were killed in the war, and only one-third of the annual increase in the population of Japan.

There is considerable evidence to show that the inhabitants of advanced countries are much more likely to move to other independent civilized countries than to their own colonies. Many colonies acquired by nations in recent years are almost uninhabitable for the people of these nations, or are already densely populated by natives. Even when conditions in the mother country and colony appear to be fairly similar, it is often difficult to stimulate emigration. Thus, the Japanese declined to emigrate to South Manchuria because of lower standards of living there, because the climate was somewhat more rigorous, and because their favorite food, rice, could not be grown readily in all parts of the colony—and this despite the expenditure of large sums by the Japanese Oriental Development Company to encourage emigration. Of course, some nations acquired colonies long ago which were more suitable for colonization, but most of the recently acquired colonies have failed to attract large numbers from the mother countries.

We may also note here the fact that the nations which, in the last few years before World War II talked most and loudest about the pressure of population and the need for room to expand—such as Italy, Japan, and Germany—were not, after all, unusually densely populated. Before entering on their campaigns for expansion, these three countries had a population of 133, 135, and 140 persons, respectively, to the square kilometer, while Holland, England, and Belgium had 232, 264, and 266, respectively.[7] There were, to be sure, some differences between these countries in their per capita holdings of arable land and natural resources. But it is likewise true that those countries which complained most about population pressure seemed to go out of their way to increase this pressure by attempting to raise the birth rate.

[7] *The Economist*, London, England, April 18, 1936.

Food and Raw Materials. The value of colonies as sources of food and raw materials has been somewhat greater than their value in providing relief from population pressure, but even here it is easy to overestimate their importance. While access to raw materials is vital to industrial nations, it should be remembered that colonies do not grant monopoly privileges, but merely give the mother countries first claim upon such materials, plus some profit from their exploitation. Very seldom do the colonies of any one country have anything approaching a complete monopoly over an important raw material or resource; and even if they should have exclusive control, the abuse of such monopoly power would almost surely lead to retaliation by other nations. Control over raw materials is of little use to an industrial country unless it has markets for its manufactured products, and these depend upon the development and efficiency of its industries. If a country is so efficient industrially that it can command foreign markets, it can usually secure its raw materials and foods more cheaply by purchasing them in the world markets than by conquering and developing colonial sources of supply.

Indeed, individual industrial countries have seldom found themselves discriminated against in the matter of access to foods and raw materials, except in times of war. Colonies often favor the mother countries in such matters, but usually furnish these products to all other industrial nations on equal terms. At times, the control of the raw materials of colonies has made things difficult for all industrial nations save the mother country, but not for any country in particular. But, it may be asked, are not colonial sources of supply important in time of war when other sources are cut off? The answer is that such sources of supply are of little value at such times unless the mother country controls water or land routes to its colonies, and such control is often exceedingly difficult to maintain.

Markets. Colonies are of some value as markets for products of the mother countries, but here again their importance is easily exaggerated. Colonial trade is often captured by foreign countries which have the special advantages of unusual efficiency or of favorable location with respect to the colonies. We may cite, by way of example, the inroads of the Japanese textile industries upon the trade of the British colonies. Moreover, colonies in their original state are of little use as markets for the mother country; and an economic and industrial development which would enable them to buy extensively

from the mother country is likely on the contrary to make them better able to supply their own needs.

This point is illustrated by the fact that, by 1934, Japan was already reported to be uneasy about the development of new industries in Manchukuo which had begun to compete effectively with similar industries in Japan. Low wages in Manchukuo were said to have given that country advantages in the production of iron and steel, flour, soya bean products, and brewery products. Japan was particularly disturbed over plans for new cotton and wool mills in Manchukuo.[8] In any case, the extent of colonial trade would be difficult to underestimate. In 1934, England's trade with her colonies, except those which were wholly or partly self-governing, amounted to only 10 per cent of her exports and 7 per cent of her imports, while Germany's colonial trade in the pre-war years of 1912 and 1913 amounted to but six-tenths of one per cent of her exports and one-half of one per cent of her imports.[9]

The Question of Concessions. Concessions obtained by industrial nations in regions which are not politically controlled often appear to be economically justifiable. They may permit the development of backward regions, while retaining a considerable degree of control for, and bringing in some revenue to, the conceding government. To avoid controversy, they should be given for definite periods of time and for well-defined areas only, with adequate safeguards for the nations granting the concessions. It is particularly important, moreover, that they be granted according to the principle of the "open door." That is, the people of different nations should all have opportunities to obtain these privileges. When concessions are inexactly defined, and unequal opportunities are given to the people of different nations, international rivalry is stimulated and bitter diplomatic conflict often results, which may at any time lead to more serious international conflict. The United States has often been involved in trying to protect American concessions and concessionaires in backward areas from hostile treatment by the governments of these regions, or from the depredations of bandits or revolutionary elements. We have at times landed our marines and engaged in actual combat with armed forces which presumably endangered the safety of our properties and citizens, and have taken over or supervised the revenue systems of backward areas in order to safeguard our in-

[8] *Ibid.*, June 9, 1934.
[9] *Ibid.*, April 18, 1936.

terests. Such activities are, of course, dangerous from the international point of view.

Final Estimate of Imperialism. In general, then, the fruits of imperialism have not come up to expectations. Often the policies of industrial nations in backward areas have failed to bring these nations the expected economic advantages. And when successful in this respect, they have frequently led to international friction and ill feeling, and to the development of retaliatory policies and devices. Doubt and fear pervade the atmosphere in a world where the distribution of vital supplies of food and raw materials is left to such devices as discriminatory tariffs, imperialistic policies for undeveloped areas, and monopolies and controls over raw materials. Moreover, international resentment is likely to lead nations to substitute a suddenly destructive course of action for one which is only gradually destructive of economic welfare. In other words, economic warfare may give way to military warfare, undoubtedly to the lasting detriment of all the nations concerned. In the modern world it is silly for any nation to attempt to acquire important territories and resources by military conquest unless that nation is capable of conquering and subduing the world as a whole. And this task, as the two major wars of the twentieth century have indicated, appears to be an insuperable one.

Economic Self-Sufficiency

In following a policy of economic self-sufficiency, a nation attempts to produce within its own boundaries all the goods which are necessary to its economic life. Such a policy may be regarded in part as an alternative to imperialism, and in part as preparation for and a tool of war and imperialism. The fascist economies of Italy and Germany were noteworthy for their pursuit of this policy, and we shall draw upon them in illustrating and appraising it.

Increases in Production. A program of economic self-sufficiency is likely to include three parts or phases, one of which is an attempt to stimulate the production of goods the output of which was formerly insufficient for domestic consumption. This phase of the policy is typified by the "Battle of the Wheat," as Italy called her campaign to increase wheat production. Within a few years after 1925, she greatly increased her output of wheat, and announced that it was no longer necessary to import significant quantities of this grain.

While Italy carried on a large-scale land reclamation program, wheat production was increased primarily by raising the yield of land already in cultivation. The government encouraged the use of fertilizers and farm machinery, induced farmers to plant selected seed-wheat, obtained price reductions for chemical fertilizers and fuel for tractors, carried on research, and furnished technical aids. An intensive propaganda campaign was also carried on. However, the chief factor in increasing wheat production was the high price which the government succeeded in maintaining. Very high tariff duties were placed on wheat, wheat derivatives, and wheat substitutes. The duty on wheat itself was as high as 75 lire per quintal (3.7 bushels), or more than $1.00 per bushel. Regulations required the use of minimum percentages (sometimes as high as 99 per cent) of home-grown wheat in flour-milling.

The victory was costly to the Italian people, since it raised the prices of all wheat products, and in turn decreased the consumption of such products by about 15 per cent between 1925 and 1935. The total cost of wheat to Italian consumers increased by some 32,000,000,000 lire over the same period.[10] The high prices of wheat and related products seem to have unbalanced Italian agriculture. Farmers abandoned the fruits, vegetables, nuts, grapes, and livestock, for which much of the land is suited, and turned to wheat-growing. Decreased imports of wheat were offset by decreased exports of fruits, oils, and wine, and by increased imports of meat; so that some observers feel that there was scarcely any net gain in the matter of international trade, while standards of living definitely suffered. Similar results were obtained in other parts of this phase of the self-sufficiency program.

The Development of Natural Substitutes. A second phase of the self-sufficiency program involves the development of natural substitutes, or the attempt to use articles which are available in rather large amounts in the place of others which are much scarcer. Examples are the use of alcohol mixtures as motor fuel, castor oil as a lubricant, electric power in the place of coal in railway transportation, plastics for steel in manufacturing, glass for metal in containers, aluminum in the place of tin, zinc in the place of brass and bronze, copper in the place of lead, and more concrete and less steel in building construction.

[10] E. R. Sikes, *Contemporary Economic Systems,* New York, Henry Holt & Company, Inc., 1940, p. 427.

The Development of Artificial Substitutes. The final phase of the self-sufficiency program is the development of artificial substitutes, or the use of synthetic materials in the place of natural products which cannot be produced at home. In this field, textiles made from artificial "wool" (developed from both wood fiber and skimmed milk) partly supplanted wool and cotton materials in the fascist countries. Synthetic rubber and synthetic gasoline were also produced in substantial quantities. Fish skins were made into imitation leather, and potato peelings into "linoleum" and "corks." An "excellent" butter was made from coal tar. It was discovered that 32 pounds of cheap fish would yield one pound of extract which was said to equal 160 eggs in food value. The German authorities claimed that a saving of 400 million dozen eggs a year was possible through the use of these "Viking eggs." [11]

The Effects of Self-Sufficiency. The economic consequences of the self-sufficiency program in the fascist countries were not wholly satisfactory. Since farmers and other extractive producers were led to carry production beyond the point at which, as private enterprisers, they would normally have stopped producing, they got into the field of higher costs, with the result that prices were high and individual consumption was restricted. In general, the natural substitutes were less satisfactory than the goods which they replaced. If, for example, better buildings could be constructed by using more concrete and less steel, it is reasonable to suppose that builders would have realized this fact, and acted upon it, long before the adoption of the self-sufficiency policy.

There is abundant evidence that many of the artificial substitutes were mere makeshifts, and that they did not come into popular favor. In the first place, these substitutes were usually costly. Synthetic gasoline cost 3½ times as much as imported gasoline would have cost, synthetic rubber about 4 times as much as natural rubber, and the lowest-priced textiles of artificial wool some 30 to 40 per cent more than natural textiles. Second, these substitutes were often of poor quality—clothing made of artificial wool was stiff, heavy, and disposed to retain moisture, and some at least of the synthetic gasoline was too poor in quality for use in aviation, according to some experts. Finally, the manufacture of substitutes gave rise to fresh problems elsewhere in the economy. If textiles are made of

[11] P. T. Ellsworth, *International Economics*, New York, The Macmillan Company, 1938, p. 506.

milk or wood, the result may be a shortage of these two essential goods. The use of synthetic rubber in manufacturing required different types of machinery from that used in the processing of natural rubber. Funds had to be found for financing the productive facilities required in producing the synthetic substitutes; and these funds were often taken from established industries, with the result that plant and equipment in these older industries were allowed to run down, and their products became higher in price or poorer in quality, or both. A policy of economic self-sufficiency may be necessary in time of war, but on economic grounds it is a poor substitute for dependence on other countries for essential foods and materials.

The Control of Raw Materials by Producing Nations

Though our discussion has related specifically to the attempts of industrial nations to control sources of supply, we must not overlook the fact that the areas producing food and raw materials have themselves taken a hand in playing the game of restrictionism. While raw material controls have sometimes apparently been set up by groups of individuals or companies in the producing areas, it is usually true that the governments of these areas are genuinely, even if indirectly, interested in the proceedings.

The Conditions for Control. The effective control of a raw material by producers is possible only if certain necessary conditions are met. In the first place, the commodity should be one which originates largely in a single country, although control has sometimes been made effective through the cooperation of two or more producing countries. Again, the material should be capable of being stored over considerable periods of time without deterioration, so that it can be withheld from the market indefinitely if necessary. Third, the principal demands for the material should come from prosperous areas where the burden of rises in price which may occur will not be likely to stir up trouble for the controllers. Finally, the material should be such that new sources of supply cannot be developed except over a considerable period of time. Of course, if the commodity is a mineral which occurs almost entirely in a single area, potential competition is not much to be feared. Among vegetable products, however, those most easily controlled are commodities such as coffee and rubber, in which competition can develop only over the period of six or seven years which is required to bring a plantation into profitable operation.

The Purposes of Control. The principal object of the control of most raw materials is revenue for both the government of the producing country and the individual producers of the goods in question. The government usually obtains its revenue through an export tax on the raw material. Such a tax is likely to be particularly heavy when the country has a virtual monopoly of the desired good, for then the burden of the tax will tend to be paid by the users abroad. Occasionally such control will take the form of a governmental monopoly, and in such cases the revenue for the government is derived from the enhanced prices which the control permits.

The revenue for the producers of the raw material comes from the high prices which they can charge when the production or marketing of the material is regulated under the control scheme. The participation of the government in the plan may run all the way from the mere collection and dissemination of information or the development of a plan for cooperation by the producers, to the passage of legislation for the restriction of output or the maintenance of prices. At any rate, the operation of control plans has often resulted in greater profits for the producers, or has at least permitted them to avoid losses which might otherwise have occurred.

Since these controls are almost never used by industrial nations, but are instead the product of regions which are economically undeveloped, a third purpose of control is sometimes present. This is to protect and encourage the domestic industry utilizing the raw material in question. Of course, the most common method of protecting an industry is to impose an import duty on the finished product. The same result, however, may be reached, especially when the raw material is largely located in one country, by insuring, through a control plan including an export tax, that the users of this material abroad will receive it on less favorable terms than domestic manufacturers. At times there appears to be no intention of building up an industry in the region producing the raw material. In such cases, if the region is a colony, the manufacturing industry in the mother country is often fostered instead by means of a rebate of a portion of the export tax applied to the raw material.

The Control of Raw Materials by Producers. The various raw material controls may be divided into four groups, according to the degree to which the government of the producing country is interested in the plan. In some cases the control is left for the most part to the producers, with the government taking an indirect interest in

the proceedings. An example has been the Chilean control of nitrates. Some form of nitrogen is essential in the production of fertilizers, dyes, drugs, and explosives. For many years the only large source of nitrates was the deposits of sodium nitrate in Chile, and the producers have long been organized for the control of this important material.

Their organization was called the Chilean Nitrate Producers' Association, and it controlled the production, sales, and prices of over 90 per cent of all sodium nitrate sold throughout the world. The policy of the Association has been, in general, to charge as high prices as the traffic would bear, and they have certainly been well above those which might have been expected to prevail under conditions of competition. Earnings on invested capital amounting to 25 to 50 per cent and higher have been reported.[12] The Association has also restricted production whenever it has been deemed necessary.

The Chilean government has manifested its interest in the industry in many ways. In 1919 and 1921 it approved the statutes of the Association, and it has assisted in bringing producers into the Association. The government has been represented by four members out of the eighteen on the Association's board of directors, and has assisted the industry through reductions in railroad rates and exemptions from import duties on the bags used in shipping nitrates. Nevertheless, the participation of the government in this control has not been so direct and obvious as in other cases in which raw material controls have been provided for by legislative enactment and governments have bought up and withheld supplies of raw materials from the market. It is also true that the heavy export duty imposed upon nitrates by the Chilean government has been a great burden on the industry at times. This duty has usually amounted to a third or a half of the export value of the nitrates. Though its incidence has probably been in part upon the producers, a large part has also been borne by the consumers, many of whom are in the United States. One writer states that this duty over a period of years cost American consumers about ten million dollars annually.[13]

Competition between Chilean nitrates and nitrogen from other

[12] B. B. Wallace and L. R. Edminster, *International Control of Raw Materials,* Washington, Brookings Institution, 1930, p. 50.

[13] W. S. Culbertson, "Raw Materials and Foodstuffs in the Commercial Policies of Nations," in *Annals of the American Academy of Political and Social Science,* March, 1924, p. 80.

sources became keen in 1927. Manufactured nitrogen, obtained from the air by a process of "fixation," is the principal source of this competition. Conditions became so serious in 1929 that a three-sided agreement was made between the Chilean Nitrate Association and English and German producers of synthetic nitrogen products. This combination controlled practically all nitrogen production for a time, and attempted to regulate production, divide up markets, and fix prices according to the best interests of the parties in control. However, the combination was less successful than the Chilean Nitrate Association of earlier years. One reason was that the United States developed facilities for producing large quantities of nitrogen, and could meet her requirements completely in case of emergency.

Raw Material Control by Legislative Enactment. The severe depression in the rubber industry following World War I and the failure of attempts to promote voluntary cooperation among the growers, led to the passage of legislation in British Malaya and Ceylon in 1922 which has come to be known as the Stevenson Restriction Act. The purpose of the Act was to bring back prosperity to the rubber growers by raising prices through the restriction of exports and control of production. The operation of the Act was somewhat complicated. Each plantation was assigned a "standard production" based upon its production for 1920, with allowance for new areas. "Standard production" for most plantations probably ran around 80 to 85 per cent of capacity. Exportation at the minimum rate of export duty was permitted to each plantation up to a certain percentage of standard production. For greater amounts, the export duty became so heavy as to prohibit exports, for all practical purposes. The percentage of standard production which could be exported at the minimum rate of export duty varied as the price of rubber in London oscillated about a "fair price" per pound.

The Stevenson Act had the effect of restricting the output of rubber, at least temporarily, and also encouraged speculation in rubber. It was successful in stabilizing conditions in the industry and in bringing prosperity by raising prices, but just how much credit for the rise in prices should go to the Act and how much to other factors is not apparent. At any rate, the spot price of rubber in New York rose from a low of 13.9 cents a pound in August, 1922, to the high mark of $1.048 a pound in November, 1925, and then fell to

18 cents in December, 1928.[14] During this period, immense profits were made by the rubber producers. Dividends for British rubber companies, which had ranged between 6 and 12.5 per cent in 1923 and 1924, varied between 17.5 and 55 per cent in 1925 and 1926. One estimate has it that this raw material control cost the United States about $540,000,000 from 1924 through 1926.[15] Part of this extra cost was borne by the manufacturers of rubber articles in this country and part was passed on to consumers.

The decline in the price of rubber after 1925 was the result of several forces. The anxiety of American industrial consumers over future supplies of this raw material was to some extent alleviated; world production of rubber was steadily increasing, especially in non-British areas where the control did not apply; and the demand for crude rubber was lessened by means of the greatly increased use of reclaimed rubber. The Stevenson Act aroused a chorus of protest, with the United States as chief protestant. The Act was finally repealed in 1928, when it became evident that it had outlived its usefulness. This does not necessarily mean, however, that all plans for the control of rubber are at an end.

Control Through Government Aid to Producers. Probably the best example of this type of control was the Brazilian control of coffee. This plan was provided for by legislative enactment, but it differed from the control of rubber in that direct financial aid was given by the government to the coffee growers. After three successful "valorizations" of coffee, during which coffee was bought up and withheld from the market and restrictions were placed upon its export and the planting of new trees, a plan for the "permanent defense" of coffee was adopted. The law providing for such defense was passed in 1922, but the national government withdrew in 1924 and the measures for the protection of coffee were put into operation by the State of São Paulo (which produces 70 per cent of Brazil's output of coffee) in 1925. Control was placed in the hands of the Institute for the Permanent Defense of Coffee, which was composed of five members.

The main purpose of the permanent defense was the stabilization of prices through the regulation of the amount of coffee coming on the market. The State of São Paulo owned an extensive system of warehouses, in which some 8 million to 12 million bags of coffee

[14] B. B. Wallace and L. R. Edminster, *International Control of Raw Materials*, pp. 188, 189.
[15] *Ibid.*, pp. 212, 213.

could be stored until market conditions permitted their sale. Planters were required by law to turn over all their coffee to the warehouses of the Institute, and at times were able to get as much as 75 per cent of its market value as a loan from the government. Funds for loans to the planters and for general expenses were obtained both by borrowing and by taxation.

By these methods it was possible for the Institute to maintain a high level of prices for some time. Until 1927 no great accumulation of coffee in the warehouses took place because world consumption was keeping pace with production. Beginning with the bumper crop of 1927–28, however, production far outstripped consumption, and prices could be maintained at anything like a satisfactory level only by amassing a tremendous surplus of coffee in the warehouses of the Institute. It was expected that by the middle of 1930 this reserve would be only just short of the amount annually consumed in the world. The strain proved too much for the credit of the Institute, and the price of coffee collapsed late in 1929. All Brazilian banks were in dire straits because of frozen assets, and the situation was saved only by obtaining an immense loan from abroad.

Following this emergency, control of the coffee situation was again taken over by the Brazilian government. In 1931, an export tax payable by the exporter was imposed on coffee, and the proceeds were used to buy up and destroy considerable quantities of low-grade coffee. This program was continued on a larger scale in 1932. In 1933, the coffee crop was unusually large and the government decreed that planters must turn over 40 per cent of the crop for destruction, at a price covering approximately the direct (variable) costs of production.[16] In 1937, the government abandoned its attempt to control the prices of exported coffee, and, though the price fell, sales increased by more than enough to offset price decline. In 1938 and 1939, the planters gave up 30 per cent of the crop for destruction, and 25 per cent was destroyed in 1940. Coffee sold to the government for destruction was paid for at the very low rate of 2 milreis (10 cents) per bag. The State of São Paulo also bought coffee for destruction in 1940, and it was hoped that the quantity of new coffee placed on the market would be reduced from 20,000,000 to 11,500,000 bags, as a result of the two programs.[17]

[16] J. W. F. Rowe, *Markets and Men*, New York, The Macmillan Company, 1936, pp. 43–46.

[17] *Commercial and Financial Chronicle*, May 18, 1940, p. 3225.

Control by Governmental Monopoly. It is only a step from control through a governmental plan, with public funds and facilities, to control by governmental monopoly. An example of the latter type of control is the pre-war Japanese camphor monopoly. Camphor is used chiefly for the making of celluloid, and the moving picture industry is consequently dependent upon it. Camphor is also an important element in the manufacture of pyroxylin products, including non-breakable or shatterproof glass.

The monopoly control of camphor has been carried on with a dual purpose. It was desired, of course, to bring in revenue for the government, and it was hoped that the domestic manufacture of refined camphor and camphor products would be encouraged. The Japanese government has had complete control of the industry. No one could go into the forests to collect raw camphor by distillation of the wood of the camphor laurel tree except operators licensed by the government. Thus both the quantity to be produced and that to be sold at home and abroad have been arbitrarily determined. In addition, the government set both the price for the sale of camphor and the price to be paid to the operators who collected it.

The monopoly was quite successful, for a time, in maintaining high and profitable prices. The price of camphor doubled within two years after the establishment of the monopoly, and prices were well maintained in the face of constantly growing production and sales. The power of the monopoly to set a high price was greatly weakened in recent years by the competition of synthetic camphor. This product can be widely substituted for the natural camphor, and is even preferred for some purposes. Its production on a commercial scale at reasonable cost resulted in a modification of the price policy of the Japanese monopoly, which may be further modified by conditions imposed on Japan by her conquerors.

Control by an Embargo on Exports. More drastic even than monopoly control of a food or raw material is an embargo on the export of some material. Probably the example of an embargo of this kind which comes most promptly to American minds is the Canadian embargo on pulpwood. The object of such a restriction is not, of course, to bring in revenue for the government or to enhance the prosperity of the producers of the material, but rather to stimulate the growth at home of the industry which uses the raw material under restriction. For this purpose, an embargo may be very useful, but its effect upon a similar industry abroad may be serious.

The important restrictions were imposed by the provincial governments rather than the Dominion government, and varied from one province to another. They were unanimous, however, in imposing embargoes on the exportation of pulpwood taken from crown lands. Sometimes the restrictions applied partially to pulp as well. At any rate, they made it necessary for pulpwood to be turned into pulp or even into paper before it could be exported. These embargoes have been a source of great anxiety to the American paper industry, especially in the East. Our domestic supply of pulpwood has in many districts become entirely inadequate, nor can it be moved for long distances to be manufactured because of the great cost. Many of our paper mills are dependent upon Canadian sources for much of their pulpwood, and if the embargoes should be extended to apply to pulpwood from all Canadian lands or to require the manufacture of wood into paper before exportation, serious results in this country might be expected. It is true, however, that the restrictions appear to have accomplished their purpose in Canada, for her exports have changed more and more from pulpwood to wood pulp and finished paper.

The Results of Raw Material Controls by Producing Countries. These types of controls over raw materials have sometimes accomplished the desired results, and again they have not. On the other hand, they have been resented by countries that need these raw materials, suffer under the burdens imposed by the controls, and visualize a time when they may be cut off wholly from their raw material supplies. Like the measures used by imperialistic nations, raw material controls are a potent source of international friction and ill will.

International Raw Material Controls. In many cases, the attempts of individual nations to obtain high prices for raw materials have been unsuccessful. This lack of success has usually resulted from increased production of the natural material or the development of synthetic substitutes. In recent years, international combinations or cartels have sought to control the production, marketing, and prices of foods and materials. International combinations, in their several fields, have been able to control the following percentages of the world output of certain materials: Copper, 95 per cent; bismuth, 90 per cent; zinc, 97 per cent; copra, 80 per cent; and whale oil, 80 per cent.[18] These are but a few examples from a

[8] *Encyclopædia of the Social Sciences*, vol. xiii, p. 131.

long list which includes steel, aluminum, potash, cement, dyes, mercury, tin, rayon, and rubber combinations.

Several advantages are claimed for international combinations. They are said to reduce the number of middlemen and the cost of their services; to eliminate cross-hauling, the unnecessary payment of import duties, and dumping; and to cut down advertising and selling expenses. However, the usual results of successful international combinations are restricted production, high prices, and large profits.

Economic Interdependence in the Future

The National Approach. We have yet to consider what can be done about the problems resulting from the economic interdependence of nations. In general, little success seems likely to attend the efforts of any one nation to deal individually with these problems. The United States, for example, can do little when confronted by an international cartel which controls a material that we are unable to produce, or by a preferential tariff designed to exclude us from colonial markets—for the activities to which we take exception are carried on outside the jurisdiction of this country.

Action has sometimes been taken in the United States to try to improve the raw material situation, but little has been accomplished. Congressional investigations have been conducted and occasionally funds have been appropriated to promote the production in this country of materials which have been subjected to control by foreign countries. When public denunciation of some type of control has been particularly vigorous, the Department of Justice has brought suit against the American agents of foreign monopolies in the attempt to restrain their activities, but the suits have seldom been successful. The government has also been instrumental in preventing in this country the flotation of loans for the benefit of foreign material and food controls, but these loans have never failed of flotation in some other country or countries.

The principal nationalistic alternative to such feeble attempts at relief is retaliation, with control matched against control and restriction against restriction. As we have seen, however, retaliation is a dangerous policy. It almost never helps solve the original problems but, on the contrary, complicates them. There is no nation so strong that it can bring economic pressure to bear upon other nations with-

out fear for itself, or so rich in economic resources that it can be highly prosperous without placing a considerable amount of economic dependence upon other nations. If each nation carried the control of foods, raw materials, and markets to the *n*th degree, the result would be the destruction of international exchanges, and economic disaster for all.

The International Approach. There can be little doubt, then, that the approach to the problems of economic interdependence should be international in character. Although relatively little has been accomplished in the past by way of bringing about international cooperation in these matters, the prospect for the future is considerably more promising. The various international organizations which we have described in the two preceding chapters, such as the International Monetary Fund, the International Bank for Reconstruction and Development, and the Economic and Social Council of the United Nations, have among their objectives (1) the elimination or reduction of protective tariffs and export duties, export and import quotas and licensing, foreign exchange controls, currency depreciation, multiple currency devices, barter trading arrangements, and other restrictions on and obstacles to trade; (2) the stabilization of national monetary systems and foreign exchange relationships; and (3) the promotion and facilitation of international loans and investments as needed for development and reconstruction.

If these organizations operate according to plan, the result should be a genuinely international solution for the problems of economic interdependence. The nations of the world will then have access on equal terms to the foods, minerals, raw materials, and other essential products they require, and to the markets of the world on the basis of competitive efficiency in selling their products. Moreover, they will find it cheaper to buy the economic goods they need, and to compete freely for markets, than to try to conquer or otherwise secure exclusive control over areas which will serve as markets and sources of essential goods, or to follow a policy of economic self-sufficiency at home. The international cooperation which is in prospect will not directly solve the problem of population pressure, but it will help the several nations to take care of their populations as well as possible through the most effective use of their resources and those of other countries. It is too much to expect that these inter-

national organizations will operate perfectly, but they will find it difficult to produce conditions worse than those which have existed in the past in their absence.

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1. What has been the relation between population growth and industrialization?
2. How have industrialization and the development of large-scale production led to economic interdependence among nations?
3. "The United States is economically self-sufficient and need not depend on other countries for her economic welfare." Do you agree?
4. Why have colonies been sought by the great industrial nations?
5. What two tariff policies have nations commonly adopted in connection with their colonies? Distinguish carefully between them.
6. What is the difference between a colony and a protectorate? Between a protectorate and a mandate? Explain.
7. What are concessions? Of what importance are they in our modern economic world?
8. "Imperialistic adventures of nations were confined to the last century and have not been known in recent years." Do you agree? Explain.
9. Have colonies generally been helpful to industrial nations in affording relief from population pressure? Explain.
10. How important have colonies been to industrial nations as sources of foods and raw materials? Explain.
11. "Colonies have usually solved the mother countries' problem of finding markets for manufactured products." Discuss.
12. How have imperialistic policies affected the relations between industrial nations?
13. Is a policy of national economic self-sufficiency an alternative to imperialism or a tool of imperialism and war? Explain.
14. "A policy of economic self-sufficiency is likely to have three distinct parts or phases." Explain.
15. What are the economic results of the policy of economic self-sufficiency? Explain.
16. "A policy of economic self-sufficiency is indefensible on economic grounds." Explain.
17. Why have controls over raw materials been instituted by many countries producing raw materials? Explain.
18. Under what conditions are these controls most likely to succeed?
19. What has been the basis, in this chapter, for classifying controls exercised by producing countries over raw materials?
20. Give an example of each type of raw material control.
21. What have been the results of controls over raw materials by producing countries?
22. Why has the national approach to the problems of the economic interdependence of nations been both ineffective and dangerous?

23. "The prospects of a genuinely international approach to the problems of economic interdependence are now brighter than ever before." Explain.
24. What results may be expected from the functioning of the various international organizations which have recently been set up? Explain.

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PROBLEMS IN SOCIAL WASTE

16. Waste in Production

A great deal has been said and written in praise of American business. We hear much about the efficiency of production in this country. We read from time to time about improved methods of manufacture. And we see in books, magazines, and newspapers, imposing figures of exports from the United States to foreign countries—exports which, we are told, represent goods that Americans have made over and above those required for their own use.

Most textbooks on economics, also, tend to emphasize the possibilities of our present-day productive methods. Descriptions are given of measures that have been adopted to increase the effectiveness of man's efforts to convert raw materials into consumers' goods. These measures include the use of the roundabout process of production, strict attention to the most economical arrangement of the productive agents, specialization in its various forms, and, in some instances, the adoption of large-scale methods.

But we must not give the impression that all is efficiency in American business circles, for such an impression unhappily would be erroneous. To avoid presenting a distorted picture of the situation, we shall point out in the present chapter certain shortcomings of our business enterprisers which result in a very serious economic loss to individuals and society as a whole, and to the present and future generations.

The Nature of Waste in Production. Writers on economic principles usually define production as the creation of utility, and discuss in some detail the several types of utility—*form, place, time, possession,* and *service*—which are being created constantly by our great army of workers. Efficiency in production demands that these workers shall be kept employed steadily, and that the conditions under which they work shall be such as will enable them to make the most of the land and capital with which their labor is combined in making, transporting, storing, and selling goods, or in performing some other act of production.

Success in production depends upon the possession of knowledge of the best methods of production, whether in manual work or in management, and upon translating that knowledge into action. Land, labor, and capital are scarce agents of production. Whenever any of these agents is allowed to go idle, being wholly or partly unused, there is economic waste. Whenever business men are ignorant of or for some reason fail to apply the best-known methods of production, there is waste. Whenever productive agents are used in a way which yields a smaller return in output than could be had through some other use of these agents for the same length of time in the same field of production, there is waste. And whenever a valuable, irreplaceable natural resource (such as coal) is used when a relatively inexhaustible resource (such as water power) would serve equally well, obviously there is waste. We may define waste in production, then, as *any economic loss suffered by society through the inefficient use of factors of production, or through the failure of enterprisers to use certain of these factors when, from the social point of view, it would be economically wise to do so.*

Professor John A. Hobson and other writers have argued that some enterprisers indulge in waste through the production of goods which are socially undesirable, and which therefore constitute "illth" instead of wealth. This is a matter which we cannot undertake to discuss at this point, though it will receive attention in later chapters.[1] We are here concerned primarily with the efficient production of whatever goods are turned out, and not with the way they may affect society when they are consumed. Judging purely by our definition of waste in production, we should have to commend the producer of illth, provided he produces efficiently; while at the same time we should be obliged to condemn the producer of much-needed goods, if he is less efficient in his methods than the best enterpriser in his particular field of activity. For the problem of waste in production is solely one of the unwise utilization of the agents of production—land, labor, and capital.

Conflict of Individual and Social Interests. In many cases, a reduction in waste in production results in both individual and social gain. When, for example, an enterpriser lowers his costs of production through the more efficient use of coal, he not only adds to his personal profit but also promotes the conservation of an important natural resource. But there are instances in which productive meth-

[1] Chaps. 17 and 18.

ods, though socially wasteful, may be individually profitable. It may pay the owner of oil land to drill and pump feverishly to obtain oil which would otherwise be secured by owners of adjoining plots of land, just as it may pay a monopolist to restrict his output in order to charge an artificially high price for his product. But if the oil man thus renders impossible the *total* maximum production of oil from this field, as he may easily do, and if the monopolist in practicing restriction allows machinery and labor to go idle, both of these producers would clearly be engaging in anti-social acts; for, judged by the standards set up in our definition, both would be indulging in waste in production. In such instances, as always in the study of economics, we are bound to take the social point of view and to condemn self-seeking individuals for their unsocial actions.

Some Major Examples of Waste

We shall now make a brief, and necessarily a very incomplete, survey of the waste of land, labor, and capital in some of the more important phases of economic life. Unfortunately, we have almost nothing to offer in the way of *exact data,* for the reason that such data are not to be had. The field is so huge and so varied that we can never hope to secure complete information on the extent of waste in production. But the figures that we present are as good as any that are obtainable. They are, it should be said, *careful estimates* made by men who have given much study to the matter. And even if they are only "enlightened guesses," they are nevertheless sufficiently accurate to give a fair idea of the serious problem which we, as a society, face. With this word of explanation, we proceed to an examination of certain types of waste in production.

THE WASTE OF LAND

Land is defined by the economist as natural resources created without the assistance of labor. Since land is synonymous with natural resources, we shall concern ourselves, in the present section of the chapter, with examining the wasteful exploitation of some of our important natural resources. Over the extent and solidity of land, and over climate, man has little or no control; but in the case of properties of the land such as minerals, water power, natural vegetation, and soil fertility, man has it within his power to use them wisely or unwisely.

The importance of using natural resources economically, instead of wastefully, will be apparent when it is remembered that production consists, in large part, of converting natural resources, directly or indirectly, into consumers' goods. If, then, there should come a time when we have completely exhausted our stock of natural resources, we shall also be through with the production of consumers' goods.

Coal. One of our most important natural resources, because of its use in producing power and heat, is coal. We have in mind, of course, not anthracite or hard coal, but the bituminous or soft coal of which we use a half-billion tons a year, and upon which we depend to drive our locomotives, generate much of our electricity, provide coke and its by-products, and turn the wheels of an overwhelming majority of our industrial machines. And yet we treat this great natural resource as though we possessed unlimited quantities of it.

We have it on the authority of experts that for every ton of bituminous coal that is brought to the surface, another ton is left in the ground, forever beyond reach.[2] The cause is faulty mining. Apparently with no thought for the probable needs of future generations, most operators of soft coal mines practice "creaming the mine," which consists of following the rich seams of coal, taking out only that which is readily accessible, and abandoning the mine before the lean seams have been worked. After a time, the roof of the mine falls in, and what would once have been a somewhat difficult task of mining becomes virtually impossible. Systems of leasing which prevail in mining are also partly responsible for the neglect of thin seams and other high-cost areas; for the leases often call for the removal of a specified quantity of coal each year, and hence encourage the mining of those parts of the mines that may be most easily and cheaply exploited.

In the use of bituminous coal, once we have delivered it at the boiler room, we are exceedingly wasteful. According to the late Charles P. Steinmetz, the "electrical wizard," we lose three-quarters of the power and heat of every ton of coal that we burn, through faulty utilization. Another estimate is to the effect that "the average steam plant uses eight times as much coal per unit of power gener-

[2] C. G. Gilbert and J. E. Pogue, *America's Power Resources*, New York, D. Appleton & Company, Inc., 1921, p. 20.

ated as does the most efficient plant"; [3] and in the opinion of Mr. Stuart Chase, "two tons are being burned where one or less would suffice." [3] All in all, it seems very likely that if we set ourselves seriously to the task of conserving coal we could, by employing the best-known methods of mining and utilizing coal, satisfy our present needs and yet reduce the drain upon our stock of this natural resource by at least 75 per cent.

Both anthracite and bituminous coal are used in heating houses and other buildings. According to a 1942 report by Dr. William A. Hamor, Associate Director of the Mellon Institute of Industrial Research, home owners and the operators of apartment houses and office buildings could save more than $150,000,000 in fuel bills each year through proper maintenance of furnaces and more efficient firing methods. This report added that if the dwellings erected during the next ten years were properly insulated there would be an annual fuel saving of $125,000,000 to the owners.

Petroleum. The importance of petroleum has been brought home to us by the development of the internal-combustion engine, with gasoline for fuel, which during the past few decades has played so vital a part in both peace and war. Petroleum is of great significance, also, as the source of a score or more useful commodities, including kerosene, benzine, naphtha, asphalt, and paraffin. It provides us with most of our lubricating oils—a matter of prime importance in a machine age. And petroleum, in a relatively crude state, is being used in increasing quantities as fuel for locomotives, steamships, and industrial plants, and for purposes of domestic househeating.

Our record for waste is even worse in the exploitation of petroleum than in the mining of coal. Because petroleum collects in underground "pools," spreading over wide areas, it is possible for a landowner, by drilling into the pool, to secure not only the oil immediately under his own property but also—if not interfered with—much of that which lies under surrounding acres, since it will tend to flow or seep through the sand toward the outlet. On this account, the discovery of oil is the signal for all landowners to start drilling at once, in the hope of getting the oil out of the ground before others capture it.

[3] Stuart Chase, *The Tragedy of Waste,* New York, The Macmillan Company, 1926, p. 242.

The inevitable result is a needless multiplication of wells and derricks, waste in the form of excess labor, and, worst of all, gross interference with the proper extraction of the petroleum from the land. Engineers say that for the proper drainage of the oil there should not be on the average more than one well for every eight acres of land. But in many instances there is a productive well for every two acres, and sometimes the wells are so close together that the derricks seem almost to touch one another. Because of faulty technique in exploiting our oil fields, it is probable that "for every barrel of oil produced three barrels or more are left underground, or wasted in well operation." [4] This waste has been caused by the failure to apply the best methods of production that have been developed. Says the Director of the Bureau of Mines: "We have been wasteful, careless and recklessly ignorant. We have abandoned fields while a large part of the oil was still in the ground. We have allowed tremendous quantities of gas to waste in the air. We have let water into the oil sands, ruining acres that should have produced hundreds of thousands of barrels of oil." [5] And as a consequence of these and other practices it seems certain that we lose a half-billion (and possibly a full billion) barrels of petroleum a year, which we could save if only we did the best we know how to do.

Fortunately, our *utilization* of petroleum is not so wasteful. Indeed, we are probably as efficient in the field of oil-refining as in any of our great manufacturing enterprises, and far more efficient than in most. Refining is in the hands of a relatively small number of large companies, in striking contrast to the widespread ownership of oil lands. These companies, for the most part, have established research laboratories which are constantly improving the technique of refining; and as better methods are developed they are adopted rapidly throughout the industry. Here, then, is one bright spot in an otherwise gloomy picture of inexcusable waste.

Natural Gas. Closely related to petroleum, in both its occurrence and economic importance, is natural gas. Those who live in regions where this great natural resource is plentiful are well aware that it is both useful and cheap. It is in many respects better than artificial gas made from coal, and is particularly suitable for domestic purposes. And yet this valuable natural product is allowed to blow off into the air to the extent of some 600 billion cubic feet a year, ac-

[4] *Ibid.*, p. 248.
[5] Quoted in *ibid.*, p. 251.

cording to reliable estimates. In this way we waste approximately as much natural gas as we utilize. Translated into terms of present average Philadelphia prices for artificial gas, the loss is about $450,000,000 a year. This loss is very largely attributable to our faulty exploitation of petroleum; and much of the waste of petroleum results from the premature escape of natural gas. Hence, if we used scientific methods of oil production, we should at the same time reduce materially the loss that we now suffer through the waste of natural gas.

Water Power. The possibilities of water power for supplying the power, heat, and light needs of the people of this country have been greatly exaggerated. Theoretically, we could increase enormously the amount of electrical power generated by means of falling water, but practically there are very real limits to the extent of such increase. For practical purposes, we should not consider as available for water-power production any streams which cannot be relied upon to provide a steady supply of electric current, nor should we estimate the power possibilities of a stream at an output greater than the minimum which it may be counted upon to generate continuously throughout the year. Furthermore, we should exclude from our calculations the water-power potentialities of those regions which are so remote from centers of population that the current which they might generate could not find purchasers. There are, of course, many excellent streams in mountainous areas which must be ruled out, at least for the present, on this account.

Nevertheless, the fact remains that we have in the United States water-power resources which, from the social point of view, should be developed and put to work. According to estimates of the National Resources Committee, we had in this country, in 1938, the potentialities for generating some 85 million horsepower from water; and of this amount we were utilizing slightly more than one-sixth. It seems fair to say, therefore, that we could if we wished secure almost 70 million additional horsepower by harnessing our streams and thus expanding our production of electric current.

That we have not done so is attributable largely to the great cost of constructing hydroelectric plants, but also in part to the fact that bituminous coal has been both plentiful and cheap. Indeed, much of the tragedy of the water-power situation lies in the use of irreplaceable coal to the neglect of water power, which is continually being renewed. As Mr. Chase has put it: "What water power can do

is to diminish the annual amount of coal needed, and thus lengthen the life, and help to preserve the by-products, of the coal beds. . . . We have been eating into our *principal,* while allowing a steady and unending *annuity,* in the form of water power, to waste away." [6]

Replaceable Natural Resources. The waste of natural resources which we have been describing is especially serious because it constitutes an irreparable loss. Coal, petroleum, and natural gas once wasted are, for all practical purposes, gone forever, since geological ages instead of years are required for their formation. To be sure, there is always the possibility that satisfactory substitutes will be found, if and when these natural resources are completely exhausted. However, it is scarcely the part of wisdom to regard this possibility as justification for wasting these resources, when we know perfectly well how to prevent most of the waste.

Another but less dismal type of waste of natural resources has to do with natural vegetation, fish and game, and the natural fertility of the soil. In our use of these gifts of nature we have been most prodigal. There remains today but one-sixth of the "forest primeval" that was here when the Pilgrim Fathers landed in America. Through careless lumbering, preventable forest fires, and wasteful methods of manufacture, we lose some 5 million cubic feet of lumber a year, The fish that once filled our streams, and the game that roamed our forests and plains, are now excessively scarce—in some instances because man has had to turn woodland and prairies into farms, but too often because of wanton slaughter or the pollution of rivers and other bodies of water. Our natural soil fertility, which made common a yield of forty bushels of wheat per acre in pioneering days, has given way to impoverished land which, planted year after year to the same crop, now produces but a quarter as much as it should. More pitiful still are those very considerable areas which have suffered erosion by wind or rain and are now wholly unproductive, though once they provided a livelihood for thousands of families.[7]

Without condoning the misuse of these important natural resources, there is no need to regard the situation as hopeless. For the remedy lies clearly within our own control, and may be applied as soon as we recognize our misdeeds and highly resolve to make amends. Not overnight, it is true, but in the course of a generation

[6] *Ibid.,* p. 245.
[7] This and other problems of agriculture are treated in chap. 20.

or so, great oaks from little acorns grow; and forests of oak, pine, and other important varieties of trees will soon be ours, once we undertake seriously to rebuild our denuded forest areas. The reforestation movement, carried on by the Civilian Conservation Corps under the administration of Franklin D. Roosevelt, made definite progress in this direction; but private as well as governmental agencies must join in the conservation movement if we are to provide for ourselves and our posterity an adequate, continually renewed supply of timber.

The remedy for the rapid decline of wild life is not so clear. We have done something in the way of conserving this resource by providing "closed seasons," during which fish and game are protected. We have replenished our streams with fish from hatcheries, and encouraged the multiplication of wild animal life by stocking our national parks and state game preserves with needed types of animals and giving them adequate protection. We could, and unquestionably should, reduce the pollution of our waters, in the interest of human health as well as the preservation of our supply of fish. But we have, after all, passed the "direct appropriation" stage of economic development, in which man lives chiefly by taking the things provided by nature and using them directly rather than indirectly. In our present-day agricultural and industrial life, it is doubtless inevitable that we should minimize the importance of our wild-life resources and utilize our land in ways which will cause it to yield, acre for acre, more product than we should get if we set apart extensive areas of potential farm land for the development of wild animal life.

The problem of soil conservation is one which has been commanding much attention in recent years. Most people agree that something must be done, and done promptly, to reclaim our wasted agricultural areas and prevent further waste through unscientific farming and erosion. It has been demonstrated clearly that a farm that has been robbed of its fertility may be restored to a high state of productivity, if only the proper measures are adopted. And the necessary measures have been developed and made known by scientists who have devoted their energies to the problems of farming. Chemists, through the analysis of soils, can discover the deficiencies of given plots of land, and prescribe fertilizers that will add to the soil the plant food required for the production of desired crops. And

the United States Department of Agriculture and many similar state departments stand ready to advise how to secure the best crops without at the same time impoverishing the soil.[8]

There seems no doubt that erosion by water and destruction by floods may be lessened by giving proper attention to reforestation, and that erosion by wind suggests the planting of grasses rather than cultivated crops in the areas that are affected.[9] The problem, however, is one which cannot be solved satisfactorily by individuals, for it involves (as has been pointed out by Maury Maverick) a consideration of "great drainage areas, big rivers and little waters, dust storms, minerals, gas and oil; climates and different conditions; and the effect upon the earth of roads, bridges, cities, sewer plants and all artificial additions made by society." The Soil Conservation Service was created by Congress in 1936, in recognition of the direct responsibility of the federal government to protect the basic soil resources of the country. State planning boards, forestry and conservation associations, and other agencies are engaged, also, in the great task of reclamation and conservation of the soil. There is every reason to believe that a comprehensive program of soil conservation will be developed within a relatively short time.

THE WASTE OF LABOR

In Chapter 5, we examined in some detail the most tragic forms of labor waste, which appear in connection with the problem of unemployment.

Seasonal, Technological, Cyclical Waste of Labor. When in certain industries, because of seasonal unemployment, the most that workers can hope for is jobs during two-thirds of the year; when,

[8] "Among the most important means of increasing the yields of crops are: (1) The selection of crops better adapted to the available soils; (2) the employment of suitable rotations; (3) the use of better-adapted varieties; (4) the reduction or elmination of losses from the depredations of insects and diseases; (5) control of weeds, (6) better or more thorough methods of preparing the land and cultivating the crop; (7) larger or more effective use of fertilizers; and (8) the substitution of crops which give a larger yield per acre for those which give a smaller yield."—From *Yearbook* of the United States Department of Agriculture, 1923, p. 464.

[9] According to the United States Department of Agriculture, erosion in the United States had, as of 1938, "ruined for cultivation" 50 million acres, "severely damaged" 50 million more, removed from one-half to all of the top soil from 100 million acres, and left another 100 million in the condition described as "erosion process beginning." (*The Economic Almanac for 1945–46*, p. 26.)

because of technological unemployment, thousands are permanently laid off from occupations for which they have prepared by long training, and in which they had expected to find a lifetime of remunerative work; and when, as from 1930 to 1936, millions of able and willing members of our so-called labor army plead for work and get only a dole—there is no denying that our economic order is wasteful of labor.

The waste of labor is particularly costly. For labor that is not used when it is available is gone forever, like the unused water-power resources to which we referred earlier in the chapter. Moreover, the human beings whose labor is spurned must in any event be given maintenance, however inadequate it may be; and this subsistence charge constitutes a running expense for which society gets no return whatsoever in the form of economic goods. There is also, of course, an incalculable cost in the destruction of human values. For one of the sorriest consequences of unemployment is the broken morale suffered by men who, through long-continued enforced idleness, are finally driven to the conclusion that they are of no account in our economic life, since there is nothing they can do that the world wants done. Though these "human costs" are not measurable in dollars and cents, they are none the less a social burden, even in the strictly economic sense; for the continually unemployed become eventually *unemployable*, they consume at public expense at least a little though they produce nothing, and thus they are a perpetual drag upon society.

Undermanned and Overmanned Industries. A study by the Brookings Institution undertook to "measure the productive capacity of such labor as was at hand [in the United States in 1929] but was used to an amount less than it would have been able and willing to render if a larger demand had been forthcoming from the labor market. In a word [this study sought] to measure the 'practically attainable' capacity of the national labor force which we had" at that time.[10]

This survey disclosed the fact that much labor is going to waste in this country, because some of our important industries are undermanned while others are overmanned. For example, to utilize fully the plant capacity in the field of mining, it is estimated that 70,000 more workers would have been required in the prosperous days of

[10] Edwin G. Nourse and associates, *America's Capacity to Produce*, Washington, Brookings Institution, 1934, chap. 19.

1929. And to operate to capacity all of our manufacturing establishments, we should have had to add to American industrial payrolls 1,000,000 more workers than they then employed. Hence, these industries were undermanned, in the sense that they had either too few workers or too much plant. If society needed the products that these industries were *capable* of turning out, then obviously the plants were undermanned; if society could not have used these products advantageously (which is scarcely thinkable, as we shall point out later) the industries in question were guilty of wasting capital—a form of waste which we shall discuss in another section of the present chapter.

But waste of labor through overmanning is practiced quite as extensively as waste through undermanning. The Brookings investigators estimated that "actual agricultural production did not utilize the labor which remained nominally attached to that industry at anything like full practical capacity," and that 500,000 agricultural workers could be spared from our farms without causing a labor shortage.[11] Other estimates of overmanning, as of 1929, included 20,000 excess workers in forestry and fishing, 270,000 in the construction industry, 10,000 in transportation and communication, and 290,000 in public, domestic, personal, and professional service. These are people who, in the words of Gilbert and Sullivan, "never would be missed" if they were to leave the industries to which they have nominally been attached. They are people who are not needed in these industries, whose presence does not increase production, and whose retention is therefore in the nature of waste of labor. This labor should, of course, be released from these several industries, and applied in lines of economic activity where it can be utilized to advantage.

Waste of Labor "on the Job." The possibility of releasing these thousands of workers, so that they might make themselves genuinely useful elsewhere, is dependent upon the better utilization of the labor of those who remain to "carry on." In many instances, the so-called excess laborers can be spared only if those who are left on the job are employed more efficiently, through better training, better management, and better working conditions.

Much of the progress that has been made in recent years through the introduction of scientific management has resulted from providing working conditions that have enabled the workers to do their

[11] *Ibid.*, p. 410.

best. The adjustment of seats and work benches to meet the needs of individual workers, modifications in lighting to remove eyestrain, proper attention to temperature and humidity—these are examples of improvements in physical equipment that have been known to increase the efficiency of labor greatly. There is, for example, the case of a change in temperature from 73 to 68 degrees Fahrenheit which brought an increase of 63 per cent in the output of typists working in the office in which the change was made.

Economy in the use of labor demands that a worker's native talent shall be developed to its fullest, that the worker shall be given the highest type of work that he is capable of doing and that type only, that he shall not be allowed to sit around waiting for materials which should be on hand, that he shall be protected against preventable illness and accidents, and so on. When these and other fundamentals of economy in the use of labor are not practiced, society loses because it fails to get from its labor force as much production as it might have. There is the further fact that workers must be fairly well contented if they are to give their best efforts to production, as regards both quantity and quality. Realizing the dangers of having dissatisfied employees, some progressive business concerns have established personnel departments, or at least hired a personnel director, whose job it is to promote good feeling, lessen friction, and look after the well-being of the workers as well as the interests of the employer. But it must be said that the vast majority of business establishments in this country are still being conducted largely on an unscientific basis. As scientific management and personnel administration are able to show concrete results, and as their advantages become more generally recognized, they may be expected to make headway and achieve a wider adoption. In the meantime, inefficient management and real or imaginary grievances between employers and employees will continue to be a common source of waste of labor.

Waste in Youthful and Aged Labor. In 1930, more than 2,000,000 of the gainfully occupied in the United States were boys and girls ranging from 10 to 17 years of age; and more than 2,000,000 others were men and women 65 years of age or older.[12] It might appear,

[12] *Statistical Abstract of the United States, 1937,* p. 53. It seems reasonable to suppose that the Fair Labor Standards Act of 1938, by prohibiting the employment of children under sixteen in the manufacture of goods entering into interstate commerce, will eventually bring about a substantial reduction in child labor in the United States.

at first thought, that the use of the youthful and aged in industry meant a very complete utilization of our labor supply, and consequent social economies. But the seeming benefits of using very young and very old workers are illusory. The error arises, as Professor Hobson points out, "from a short-sighted view of the interests of the single person or his single family, instead of a far-sighted view of the welfare of the community. It is often a source of immediate gain to a working-class family to put the children out to wage-earning as early as possible, and to keep old people working as long as they can get work to do. It does not pay the nation, even in the economic sense, that either of these things should be done." [13]

Waste in the use of child labor consists partly of the physical and moral costs that result from subjecting young people to long-continued labor, mostly of a monotonous nature, in environmental conditions which are not always wholesome. It consists, also, in large part, of the lessened opportunities which will be theirs because they spend some years in earning which should be given over to self-development. And it must be remembered that society as a whole loses whenever its members fail to develop their abilities fully. Society loses the larger product which it might have had, and in some instances has to support in old age those whose life earnings would have made them self-supporting had their early training not been so limited. From both the individual and the social points of view, the early years of life are spent best when they are devoted to forms of development which will prepare the individual for greater productivity and enjoyment of life in his mature years.

Of labor in old age, we may say that, in general, it is neither humane nor economically wise to keep people of advanced years steadily at work. Work that is easy for those in middle life may be excessively hard on the aged, and, moreover, the old workers in a plant are often a drag upon production. It seems especially silly to allow our time-worn industrial veterans to remain on the job, while able and more vigorous workers walk the streets in search of employment. Yet this is precisely the situation which prevails regularly in American industry. For we have, even in our most prosperous years, an army of unemployed numbering at least a million and a half would-be workers, and at the same time keep on the job large numbers of those who have seen long service and might well be

[13] J. A. Hobson, *Work and Wealth*, New York, The Macmillan Company, 1926, p. 80.

honorably retired. Of course, such retirement would involve the necessity of providing adequately for these venerable soldiers of industry, as we saw in our treatment of economic insecurity. The point to be emphasized in connection with this brief survey of waste in labor is that we shall not be using our labor to the best advantage, so long as we keep the very young and very old members of society employed and allow the able-bodied, willing, middle-aged to go without jobs.

THE WASTE OF CAPITAL

The factory buildings, machinery, tools, and other equipment which the economist calls capital are of the utmost importance to society, in that they contribute *indirectly* to the satisfaction of human wants. But since they are not capable of yielding human satisfactions *directly*, they have social usefulness only so far as they are utilized in the production of consumers' goods. Capital which is not used at all, or is used inefficiently, or is used unnecessarily, is capital wasted in whole or in part. It is not difficult to show that we have in the United States much capital of these kinds.

The Problem of Unused Capital. When a plant fails to turn out as large a product as it is equipped to produce, it is wasting capital since the whole or a part of its equipment is idle. Such a condition is referred to by economists as "overcapacity," "excess capacity," or "unused capacity."

A number of estimates have been made of the unused capacity of various American industries. A committee of qualified engineers reported, in 1921: "Clothing factories are built 45 per cent larger than is necessary; printing establishments are from 50 per cent to 150 per cent overequipped; the shoe industry has a capacity of 1,750,000 pairs of shoes a day, and produces little more than half that number." [14] Mr. Stuart Chase in 1926 quoted estimates to the effect that there was overcapacity amounting to 20 per cent in blast furnaces, 70 per cent in steel plants, 50 per cent in copper smelters, 75 per cent in lumber mills, and 50 per cent in sugar refineries.[15] To bring the story more nearly up to date, we may cite the report of the Brookings Institution giving figures for 1929, and estimating an excess productive capacity in twenty-seven selected manufactur-

[14] Federated American Engineering Societies, *Waste in Industry*, New York, McGraw-Hill Book Company, Inc., 1921, pp. 17, 18.
[15] Stuart Chase, *The Tragedy of Waste*, pp. 186, 187.

ing industries, which ranged from a low of 2 per cent in the manufacture of dairy products to a high of 55 per cent in locomotive manufacture. The Brookings conclusion for manufacturing as a whole was that 17 per cent of the equipment was unutilized in 1929—the figure being 20 per cent for the five-year period from 1925 to 1929, inclusive.[16]

Some Causes of Excess Capacity. Excess capacity, with its inevitable waste of capital, results at times from the seasonal nature of an industry. The clothing industry, for example, must be prepared to produce as much output as the market will absorb when the demand for clothing is at its height; and this means an equipment in excess of that needed at other seasons of the year. Sometimes the cause is to be found in the mushroom growth of an industry, as in the manufacture of radio receiving sets in the 1920's. In this case, once the initial demand for radio sets had been met and the novelty of radio had worn off, it was found that the capital that had been put into the industry was far greater than was needed to provide sets for first purchasers and for replacement of worn-out instruments. In like manner, the great popularity of silk goods in recent years led to the multiplication of looms and other equipment for making silk, with the result that many of the individual silk mills are today excessively large and the number of mills is far too great for present requirements of the trade.

The production and sale of petroleum products afford an excellent illustration of overcapacity in several branches of a single industry. We have already spoken of the inexcusably large investment in drilling and pumping equipment. In some oil regions, largely because of the unduly rapid exploitation of the fields, the extension of pipe lines proceeded apace, and the transportation facilities later represented a very large percentage of overcapacity. The temporary shortage of gasoline in the eastern part of the United States in World War II did not result from a normal shortage of transportation facilities, but from a diversion to fighting areas of "tankers" which ordinarily carried motor fuel from the oilfields to the Atlantic seaboard. According to the Brookings Institution, only about 80 per cent of the equipment of our oil refineries was being used from 1925 to 1929. Of course, the unusual demands of World War II brought about a fuller utilization of this equipment. Finally, the un-

[16] Edwin G. Nourse and associates, *America's Capacity to Produce*, p. 307.

warranted multiplication of automobile service stations is apparent to all who use our highways. It is estimated that the needs of automobilists and users of other motor vehicles could be met adequately with one-third the present number of filling stations, and that the unused capacity in this single item means an overinvestment of upwards of a billion dollars.

We must not overlook the fact that waste may result from capital being misused quite as well as from its not being used at all. The reports of investigators seem to show conclusively that much of our industrial equipment that sees daily service is utilized so inefficiently that a smaller quantity properly employed would be equally productive. Obviously, capital that is badly used is partly wasted. There is much waste, also, through the failure of business men to replace antiquated capital with that of the most improved types. On this point we shall have more to say in the next section.

The Responsibility for Waste

It is an easier matter to describe waste in production than to allocate fairly the responsibility for such waste. However, it is safe to say that some of the waste in our economic life is chargeable to the enterprisers and workers who carry on our productive processes, some is chargeable to the whims of consumers, and some to the nature of our economic system itself.

The Wastefulness of Employers and Employees. The report of the Federated American Engineering Societies, to which we have referred, undertook to place the blame for waste in six important fields of production. The division of responsibility for waste in industry, as arrived at by these investigators, is shown in Table 20. "Over 50 per cent of the responsibility for these wastes," reads the report, "can be placed at the door of management and less than 25 per cent at the door of labor, while the amount chargeable to outside contacts is least of all."[17] This conclusion has done much to dispel the once prevalent notion that business men are generally efficient and workers inefficient, and that employers strive always to keep production up and costs down while employees usually do only as much work as they must to hold their jobs.

"Management, the unseen force which drives all that is physical within a factory, is by far the most important factor of the present

[17] *Waste in Industry,* p. 9.

TABLE 20. RESPONSIBILITY FOR WASTE IN PRODUCTION IN SELECTED INDUSTRIES [a]

Industry Studied	Responsibility Assayed against Management (per cent)	Responsibility Assayed against Labor (per cent)	Responsibility Assayed against Outside Contacts (the Public, Trade Relationships, and Other Factors) (per cent)
Men's clothing mfg.	75	16	9
Building industry	65	21	14
Printing	63	28	9
Boot and shoe mfg.	73	11	16
Metal trades	81	9	10
Textile mfg.	50	10	40

[a] Source Federated American Engineering Societies

industrial age," writes an authority on scientific production.[18] "Machinery and materials may be put to work, workers may labor; but without adequate management to organize and consolidate them into a profitable, coordinate whole, to distribute the results of their work effectively, and to govern their operations during performance, this performance may become so uneconomic as to cease entirely." Since management decides in present-day industry what is to be done, and when, and how, it is not surprising that management, rather than labor, is at fault when a plant fails to live up to its productive possibilities.

The investigators for the Federated American Engineering Societies listed the chief causes of industrial waste under four headings, as below:

1. Low production caused by faulty management of materials, plants, equipment, and men.
2. Interrupted production, caused by idle men, idle materials, idle plants, idle equipment.
3. Restricted production intentionally caused by owners, management, or labor.
4. Lost production caused by ill health, physical defects, and industrial accidents.[19]

[18] Richard H. Lansburgh, *Industrial Management,* New York, John Wiley & Sons, Inc., 1928, p. 1.

[19] *Waste in Industry,* p. 8.

They found, further, that the heavy toll of waste resulted largely from the failure of many establishments to meet the high standards of the best-managed plants in the several industries that were studied. In the metal trades, for example, four and one-half times as much waste was discovered in the *average* plant as in the *best*. The ratio in boot and shoe manufacture was three to one; in printing and men's clothing manufacture, two to one; and in textile manufacture and the building industry, one and one-half to one.[20]

A later study conducted by two prominent mechanical engineers, Messrs. L. P. Alford and J. E. Hannum, estimates that if the performances of all plants were raised to the level of the best, the quantity of output would be increased 55 per cent in blast furnace operation, 73 per cent in the lumber and timber products industry, 81 per cent in machine tool manufacture, and 97 per cent in petroleum refining.[21] Yet another estimate is that of forty-five engineers and twenty-six executives in some thirty branches of production, reported by the Columbia University Commission on Economic Reconstruction in 1934. This group estimated that production in their several industries could be raised, on the average, some 85 or 90 per cent, if the best current standards of production were adopted throughout these industries; and twenty-seven engineers of the group estimated that the output of *all industries* could be increased 75 per cent "with equipment and management brought to the level of best current practice."[22]

The greater responsibility of management does not justify us in withholding criticism from workers whose attitudes and actions lead to waste in production. As is shown in Table 20, there are workers of this kind in industry; and in Chapter 3 we saw that there is sometimes a limitation of output through labor's opposition to the introduction of new machinery and the practice of "soldiering on the job." There is ample reason, then, for the Federated American Engineering Societies' statement, "It must be recognized that if management is to meet this responsibility fully it must have the cooperation of labor."[23] Waste in the conduct of business can be reduced to a minimum only through the joint efforts of employers and employees.

[20] *Ibid.*, p. 10.
[21] Columbia University Commission, *Economic Reconstruction*, New York, Columbia University Press, 1934, p. 89.
[22] *Ibid.*, p. 92.
[23] *Waste in Industry*, p. 9.

Waste Caused by Consumers. The rôle played by consumers in the tragedy of waste in production is an important one. Though enterprisers seem sometimes to produce goods and then force them upon the buying public by methods of "high-pressure salesmanship," the fact remains that to a very large extent the consumer directs production. It is he who in the main decides what goods shall be produced, and when and in what quantities they shall be made available. And his decisions are often the cause of waste in production.

In the following chapter we shall deal at some length with certain important problems in the field of consumption. We shall raise there the question of whether it is socially desirable that luxuries be produced while there is a dearth of certain necessities. But this is a question that relates to waste in consumption rather than in production. However, when millions of people insist upon purchasing much of their personal habiliment just in time for the "Easter parade," and when they buy twice as many automobiles in some months as in others, they are adding to the problem of waste in production. For they make highly seasonal some types of production which might be spread fairly evenly over the year, and thus they contribute to waste of capital and labor, as we have seen. And when in hot haste they abandon the drama and vaudeville for motion pictures, and the piano and phonograph for the radio, they render distressing and expensive a transition in consumer demand which might have been relatively painless and economical if only it had been effected more slowly.

In the present chapter we do not ask whether the "right" goods are being produced, but only whether what is produced is being produced efficiently. But it may not be amiss to suggest that if consumers made less of a fetish of fashion, and took more seriously Pope's couplet,

> Be not the first by which the new are tried
> Nor yet the last to lay the old aside,

they could have the goods they now enjoy—and at lower prices, because their moderation (by lessening seasonal and technological disturbances) would aid in reducing the wastes of production, hence the costs of production, and finally the selling prices of the goods.

The Wastes of *Laissez Faire*. In an earlier paragraph we hinted that an economic system such as ours might itself be responsible for waste in production. *Self-interest* and *free enterprise* may provide the incentive and opportunity that stimulate production, as is often suggested, but they may also lead to the waste of land, labor, and capital, as we have shown by numerous illustrations. The institution of *private property* may in general be a great aid to production, but it may also impede production by permitting a factory owner to close his doors whenever he cannot operate his plant with personal profit. *Competition* may perform the beneficent function of regulating price, holding it fairly close to costs of production; but *cut-throat competition* may drive an enterpriser into bankruptcy, and his employees and equipment into at least temporary idleness. *Large-scale production* may effect large economies, but it may conceivably grow into monopoly and result in the limitation of output. *Specialization* may increase the productivity of individuals and industries, but it may also lead to vested rights which (in the form of a tariff or subsidy) will burden a people for generations.

A *laissez-faire* economy is one in which there is abundant freedom of economic action. This means, in practice, that many enterprisers in many lines are going their individual ways, each estimating, as best he can, the probable total demand for his product, the probable output of other enterprisers in the same line, and a dozen other important items about which he necessarily has but meager information. The result is many mistakes, the production of too much of this and too little of that, recurrent business depressions, and a heavy toll of waste.

It is difficult to see how waste in production could be prevented without careful, centralized planning of output in all important lines of economic life. But such planning would put an end to free enterprise, as we have known it. Whether the gain would be greater than the loss is an open question which will have attention in our discussion of recent radical movements in foreign countries. We have sought here merely to indicate that some waste in production appears to be an inevitable feature of the American economic system of today.

1. What evidence is there that tends to show that American business enterprises are conducted efficiently?
2. Define "waste in production."
3. What, according to Professor Hobson, is "illth"?
4. "The enterpriser who gets the maximum of output from the land, labor, and capital he employs, is not guilty of waste in production, even though the goods he makes are in the nature of 'illth.'" Explain.
5. "There are instances in which productive methods, though socially wasteful, may be individually profitable." Explain.
6. Why should it be difficult to secure exact and accurate figures on the amount of waste in a given industry? Illustrate.
7. How do you account for the large amount of waste in coal mining and petroleum production?
8. Contrast the amount of waste in the utilization of coal with that in the refining of petroleum.
9. Why should a society regret particularly the failure to develop fully its available natural water-power resources?
10. There is no need to regard as hopeless the situation which has resulted from the misuse of our forest and farming land. Explain.
11. Explain the connection between unemployment and waste in production.
12. Some of the "costs" of waste of labor are not measurable in monetary terms. Explain.
13. Discuss the problem of waste as it arises from industries being "undermanned" or "overmanned."
14. Labor may be wasted, even when workers are kept steadily on the job. Illustrate.
15. "It does not pay the nation, even in the economic sense, . . . to put the children out to wage-earning as early as possible, and to keep old people working as long as they can get work to do," says Professor Hobson. Why not?
16. What is the meaning of "excess capacity"? Give at least two synonyms for this term.
17. Describe conditions which give rise to excess capacity.
18. Summarize the findings of the Federated American Engineering Societies as to responsibility for waste in production.
19. Consumers are sometimes blamed for causing waste in production. In what ways might they be responsible?
20. "Some waste in production appears to be an inevitable feature of the American economic system of today." Explain.

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17. *Waste in Consumption*

Consumption is the goal of production—man makes goods in order to have them available for use in the satisfaction of his many wants. And since consumption is the goal of production, it follows that production comes closest to realizing its full possibilities when *real income,* which consists of commodities and services, is so constituted and so distributed as to result in the individual and social maximization of utility.

Individual and Social Maximization of Utility. An individual attains the maximization of utility, or satisfaction, in the expenditure of his *money income* when he buys with it the commodities and services which yield him a larger amount of utility than would be yielded by any other assortment of economic goods that he might buy with this amount of money. Any individual who fails to maximize the utility that might be his is, economically speaking, doing less well than he might do. So, also, is the society that fails to distribute its income among its members in such a way as to attain maximization of utility. For if it is good economics for an individual to seek the maximum of satisfaction in consumption, it should be equally sound practice for a society.

Just as the individual maximization of utility requires that no portion of a person's money income shall be spent for any economic good, if greater individual utility could be had by spending it for something else, so, in like manner, the social maximization of utility would demand that, in the distribution of society's money income, no dollar should go to any person if greater social utility would be had through its going to another. With the money income so distributed, and with the members of society striving earnestly to maximize the utility obtainable from the expenditure of the individual incomes then in hand, the available land, labor, capital, and business enterprise would naturally gravitate to the points where they were most needed. Thus, these agents of production would be

allocated among the various industries in such a way as to bring forth those commodities and services which, when purchased by individuals with their money incomes, would lead to the maximization of utility for society as a whole.

The Nature of Waste in Consumption. If the principle of social maximization is sound, and if its acceptance leads inevitably, as we believe it does, to the conclusion stated above, it should be clear that any failure on the part of society to achieve the maximization of utility must be regarded as waste in consumption. We may define waste in consumption, then, as *any disutility experienced by society through the consumption of harmful commodities or services, or any loss of utility suffered through the inefficient use of consumers' goods.* Our task in the present chapter is to look about for evidences of consumption which, according to this definition, is wasteful, and then to inquire into the possibilities of reducing or eliminating consumption of this kind.

Disutility in Consumption

The Meaning of "Illth." Since consumers' goods come under the general heading of wealth, we should expect all consumers' goods to contribute to the well-being of those who use them. But some goods seem more likely to injure than to benefit the consumers. Ruskin was so strongly impressed with this fact that he coined the word "illth"—later popularized by Professor Hobson—and applied it to goods which he thought, because their use was likely to have ill effects upon society, should not be produced.

Illth is, of course, the very antithesis of wealth, since its consumption brings disutility instead of utility. Professor Hobson, following Ruskin's lead, says in this connection that "everyone will admit that many sorts of marketable goods and services are injurious alike to the individuals who consume them and to society. A large proportion of the stimulants and drugs which absorb a growing share of income in many civilized communities, bad literature, art and recreations, and the services of prostitutes and flunkeys, are conspicuous instances."[1] But the "many sorts" of goods that are referred to in this quotation are not so easy to locate in the market

[1] J. A. Hobson, *Work and Wealth*, pp. 106, 107. Our many citations of *Work and Wealth* in the present chapter are attributable to the fact that Professor Hobson (who died in 1940) was the outstanding "welfare economist" of his day, and his ideas are most fully set forth in that work.

place. Indeed, it is something of a task to enlarge the list of "conspicuous instances" drawn up by Professor Hobson, and even some of these items might not be regarded by everyone as illth. What, for example, is "bad literature"? Would it include every book condemned by the late Anthony Comstock (the crusader against obscenity who sought for years to "purify" the reading matter of the American people)—even a work that was hailed by recognized critics as great literature? And would an attempt to abolish bad literature permit to go unchallenged those sugar-coated novels which, however innocuous they may be from the point of view of morals, are weakly constructed and slovenly written, and fail utterly "to hold, as 'twere, the mirror up to Nature"?

The Scarcity of Illth. A division of consumers' goods into "wealth" and "illth" assumes the existence of an agency that is competent to pass upon such matters, and one, moreover, whose decisions would meet with the approval of the general public. But it seems to us that such a division is scarcely necessary—that a far better plan is to grant freedom of choice to consumers, keeping them informed, however, of the dangers of any goods that are likely to prove harmful to purchasers. Few kinds of consumers' goods that are offered for sale today are so certain to bring disutility, and so clearly incapable of giving utility, that by common consent they could be designated "illth." There are exceptions, to be sure. Perhaps the best examples are to be found among the so-called patent medicines and in the field of adulterated commodities. Few intelligent people would argue that a "cancer cure composed of water diluted with impure alcohol" [2] could have any curative value, or deny that it might do positive harm by delaying the application of scientific methods of treatment; and few would question that raw milk preserved with liberal quantities of formaldehyde might easily yield more disutility than utility. In instances such as these, there would seem to be ample grounds for outlawing the goods in the interests of the public health.

Disutility from Misuse or Excess Use of Goods. But when all is said and done, there are relatively few clear-cut cases of consumers' goods that could not conceivably yield utility. Such examples as may be cited result from our practice of producing for profit rather than for use, and these goods find a sale only because of the

[2] Cited in Stuart Chase, *The Tragedy of Waste,* New York, The Macmillan Company, 1926, p. 64.

ignorance of the purchasers. If we were to include among items of illth those goods which have utility-yielding possibilities but are often used in harmful ways, the number would be substantially increased. Cocaine may be used beneficially for relieving pain, or consumed destructively in developing or satisfying the drug habit. Alcohol unquestionably has its legitimate uses, but its abuse sometimes leads to drunkenness and degradation. A pistol may have social utility when carried by a policeman, but social disutility in the hands of a gangster. Finally, to cite an example of a common misuse of a consumers' good, an excess of heat in a dwelling means the consumption of more fuel than should be burned, and, at the same time and as a direct consequence of this waste in consumption, a probable increase in nose and throat ailments among those who occupy this overheated house. This sort of illustration might easily be multiplied many times, so likely is the excessive use of a consumers' good to result in disutility rather than utility.

It would seem, then, that positive disutility in consumption is more likely to result from the misuse or excess use of goods than from the consumption of goods which do not have any legitimate uses. We believe it is imperative to prohibit the production of so-called consumers' goods which seem certain to injure those who use them, and to regulate strictly—as is now sometimes done—the sale of firearms, habit-forming drugs, and other commodities and services which, if purchased by irresponsible persons, may lead to extensive or irreparable damage. But since most good things are capable of being turned to bad uses, prohibition and regulation cannot provide a complete solution of the problem. The remedy seems to lie, rather, in launching a program which will enable consumers to exercise genuinely intelligent choice in spending their money incomes. We shall deal with this matter more specifically in a later section of the chapter.

Economic Inequality and Waste in Consumption

Waste in consumption is closely related to economic inequality[3] —so closely, indeed, that it seems highly unlikely that we shall ever achieve anything even approximating the social maximization of utility in consumption without bringing about, also, something in the way of an equalization of incomes. Certainly, the maximiza-

[3] This relationship is dealt with again in chap. 18.

tion of utility would be wholly impossible in the face of the great economic inequalities which exist today.

The explanation of this statement is tied up with the principle of diminishing utility. According to this principle, the utility of a dollar is smaller to a man of great wealth than to a poor man. The loss of a dollar would mean little or nothing to Mr. Rockefeller, but to a day laborer it might mean cutting down on the purchase of food for his family. The principle is one which not only exists in academic circles, but is also in good and regular standing in the world of practical affairs. It is, of course, the theory upon which most civilized nations have built their systems of taxation. For modern taxes are, in general, based upon ability to pay, as we noted in our treatment of taxation in Chapter 10.

Diminishing Utility and Progressive Taxation. A wage earner in the United States is not required to pay any federal income tax on the first $500 of his income, on the theory that up to that point the utility of every dollar is sufficiently great to warrant exemption. But a sharply progressive surtax is imposed upon all net surtax income (which includes all income, except a $500 exemption for the taxpayer and $500 additional for each of his dependents), reaching the maximum rate of 88 per cent on that portion of any income which exceeds $200,000. The implication is perfectly clear. We have accepted the principle that the rich should make larger contributions to public expenditures than the poor, not only absolutely but also relatively, because a dollar means less to the rich than to the poor.

Current Inroads upon Large Incomes. It might be argued that the acceptance of the principle of progression for the purpose of minimizing sacrifice in the payment of taxes does not necessarily lead to an advocacy of equal (or approximately equal) incomes in the interests of maximizing utility in consumption. And yet these two ideas have much in common, and their differences seem to be those of degree rather than kind. Both are based upon the principle of diminishing utility. And though progressive taxation, as practiced today, does not take so much of our rich men's annual receipts as to bring about an approximate equalization of incomes available for individual spending, it goes in many instances much further than is generally realized.

The present federal income tax in the United States takes 67 per cent of a $100,000 income, 86 per cent of a $500,000 income,

88 per cent of a million-dollar income, and 90 per cent of a five-million-dollar-income. Though the absolute amounts that these income-getters are permitted to retain are still large, there is no denying that present-day progressive taxation imposes considerable restrictions upon the exercise of property rights in income. We do not limit the amount of income a man may *receive,* but we sometimes limit radically the amount he may *keep.* It seems fair to say that the principle of progression in taxation now has general acceptance, and that it could be used, if society deemed it desirable, to bring about a virtual equalization of incomes.

Trends Toward Social Maximization of Utility. Furthermore, the revenue derived from taxation is not being employed nowadays merely for carrying on what we ordinarily think of as the "affairs of government." Rather, it is being used increasingly to provide for human needs which we used to expect every man to look after for himself. When billions are collected from taxpayers and spent for the relief of the unemployed, as in the post-1929 depression, the process is one of taking from those who have and giving to those who have not. It is, in effect, a procedure through which society, at one and the same time, moves in the direction of the equalization of incomes and the maximization of utility. To be sure, the movement is not a particularly speedy one, but the trend is unmistakable. We are not suggesting that society is consciously attempting to achieve the equalization of incomes or the maximization of utility, but simply that neither of these propositions is so foreign to our present economic order as it might appear, at first sight, to be.

Social Maximization of Utility in Wartime. The national income of a country consists of economic goods, rather than money, though these goods are commonly expressed in terms of money. In a conflict such as World War II, the production of war supplies increases steadily, and the land, labor, and capital available for making civilian goods shrink with every passing day. However, it is important to have sufficient consumers' goods to maintain civilian health and morale, and thus insure the efficient performance of civilian functions that are essential to war production; and it is important, moreover, that these consumers' goods be distributed to the greatest *social* advantage—that is to say, in a way which will bring about the social maximization of utility.

To this end, the late President Roosevelt launched a program of

price stabilization which was aimed at holding down the *cost of living* and thus maintaining *standards of living*, so far as this was feasible in wartime. When there is a shortage of goods, it is ordinarily reflected in a rise in price, as was the case in 1920, when the price of granulated sugar rose to 30 cents a pound because there was so little sugar to be had. The prices of sugar and other unusually scarce consumers' goods were held in check reasonably well during World War II, through the use of the price controls which were described in Chapter 11. But the government found it necessary, also, to apply direct rationing to many commodities. Sugar, automobiles, tires, gasoline, meats, canned goods, and a host of other commodities were rationed, on the theory that every member of society should be assured his "fair share" of those economic goods which were very limited in quantity. We shall not attempt to describe here the procedure which was followed in allotting rations (in some instances, differential quantities) to individual members of society. The point we wish to make is that the rule of "first things first"—which is directly in line with the social maximization of utility in consumption—is commonly resorted to in time of emergency such as war; and it is being applied more and more extensively in normal times as well.

Conspicuous Consumption and Waste. A serious disadvantage resulting from great inequalities in incomes is the tendency, on the part of the very wealthy, to spend extravagantly for the sake of winning the admiration of those unable to buy on so lavish a scale. This subject is discussed elsewhere in the present volume,[4] but is introduced briefly at this point because of its obvious relationship to waste in consumption.

Nassau William Senior, a noted nineteenth-century economist, wrote many years ago about "the desire for distinction—a feeling which if we consider its universality, and its constancy, that it affects all men and at all times, that it comes with us from the cradle and never leaves us till we go into the grave, may be pronounced to be the most powerful of human passions." Since this desire for distinction commonly takes the form of competitive expenditure, it needs no argument to show that waste in consumption is bound to accompany great differences in spending ability. Among modern examples of conspicuous consumption are the $3,000,000 private home built for a well-known industrialist, the two hundred servants

[4] See chap. 18.

employed in the home of a prominent financier, the fifty-one passenger cars belonging to the several members of a Philadelphia family, and—on a somewhat smaller scale, but none the less interesting—the mink coat worn by All-American Biff, a bull terrier, "tailored for him by one of Chicago's leading furriers and given to him for a Christmas present" by his owner.[5] It is expenditures such as these that lead us to observe, in the next chapter, that "the elimination of both individual and social waste in consumption can be attained, if at all, only in a society in which incomes are substantially equal."

The very wealthy may properly be charged with much of the waste resulting from conspicuous consumption, because their large expenditures constitute a formidable part of the total waste of this kind, but there are many in the lower-income groups who must also accept a share of the blame. For just as

> Great fleas have little fleas upon their backs to bite 'em,
> And little fleas have lesser fleas, and so *ad infinitum,*

so, too, there is a hierarchy in the realm of conspicuous spenders. "Keeping up with the Joneses" appears to be no less popular among middle-class income-getters than among the multimillionaires; and the practice of living beyond one's means—which is a perfectly natural outgrowth of an unwillingness to be outshone in spending—is so common that it no longer excites comment.

Since few are wholly guiltless of spending for display, it may seem somewhat unfair to single out the very rich and charge them with special culpability. But conspicuous consumption is a social ill that originates among the economically great, and works its way down to the rank and file. Since the very wealthy set the pace that others try to follow, they must be prepared to accept a particularly large portion of responsibility for the waste in consumption that results from this lavish expenditure. It may be true, as Nassau Senior says, that the desire for distinction is the most powerful of human passions; but that is no reason why society should permit it to take the form of competitive spending, when spending of this sort must inevitably interfere with the attainment of the social maximization of utility in consumption.

[5] *New Republic,* January 13, 1937. The article cites the case of another lucky dog, Pico, owned by Edgar Allan Woolf, a motion-picture writer. "Noticing that Pico seemed to suffer from the heat, Woolf called in a refrigeration engineer and had the dog-house air-conditioned."

Individual Maximization of Utility in Consumption

We feel that our discussion of consumption thus far should have convinced the reader that the social maximization of utility cannot be achieved while we have great inequalities in individual incomes. But even if we had an equalization of incomes, there could be no social maximization unless we managed in some way to bring about individual maximization of utility in consumption. Utility is an essentially personal thing, and two individuals with equal money incomes might have to spend in widely different ways in order for each to get the most out of his income. Even in the presence of great inequalities in incomes, such as exist today, much would be gained if we could achieve the individual maximization of utility in consumption; and every advance of this kind would be a step in the direction of social maximization of utility. Anything that is done in the way of increasing individual utility in spending money income is a net gain; it not only helps the individual himself, but it also helps to bring society a little closer to the goal of the social maximization of utility in consumption. We may now examine some specific causes of the consumer's failure to get the maximum of utility from the expenditure of his money income.

Waste Through Carelessness in Purchase and Use. Success in making one's money income go as far as possible in providing for one's wants depends upon the exercise of great care in the purchase of commodities and services. It is wasteful to spend a dollar—or a dime—for one thing if its expenditure for something else would result in greater utility. This very simple point seems often to be quite overlooked. Many people—and sometimes those who can least afford it—appear to do much of their buying impulsively rather than deliberately. The sight of a chic hat in a shop window or a gay necktie in a men's furnishing store drives into limbo all thought of more urgent needs, and the thing is bought on the spur of the moment.

Another source of waste in consumption is the tendency of many people to buy without making a comparison of prices, either as between equally satisfactory brands which sell at different prices, or between competing dealers' different prices for the same commodity. The failure to buy at recurrent "special sales" such non-perishable goods as soap, paper towels, and canned fruits and vegetables often leads to paying 15 to 25 per cent more for these com-

modities than would be necessary if a little care and foresight were exercised in shopping for staple articles, many of which (being nationally advertised under copyrighted names) are clearly the same no matter from whom they are bought, or at what price. Many people, too, are likely to assume that high price necessarily means high quality, on the theory that "you get just about what you pay for." But goods are sometimes sold on the basis of "class price," with prices adjusted to the paying capacity of the customer for commodities that are unquestionably the same. Even harder on the notion that high prices mean high quality was a series of laboratory tests made on ten prominent brands of vacuum cleaners several years ago; for the tests showed that the highest-priced cleaner in the lot was the one that gave the poorest performance! Obviously, price is not always a measure of quality.

Chargeable to carelessness, also, is the failure of consumers to get the maximum of utility out of goods once they have purchased them. An examination of the contents of American garbage cans during World War I revealed the fact that large quantities of edible bread and meat were being thrown away. In the matter of converting odds and ends of food into wholesome, savory dishes, American housewives might learn much from the women of France and Germany, and thus save some millions of dollars a year with no loss in utility. The readiness with which many people discard clothing which is still entirely presentable, radio sets which are capable of giving excellent reception, and automobiles which are practically as serviceable as the latest models, is responsible for much loss of utility in consumption. Clothing and automobiles must not be expected to last forever; but if a suit of clothes is thrown away or a car "turned in" before it has given its owner the maximum of *acceptable service,* it would seem that this is waste in consumption. And unless the owner has carefully weighed the pros and cons of the situation (which is all too seldom the case), the waste may well be charged to carelessness in the use of consumers' goods. Often, of course, the retirement of an old good in favor of a new one is in the nature of conspicuous consumption.

Conspicuous Consumption Once More. Conspicuous consumption is responsible not only for social waste in consumption, but also, in all probability, for much of the failure of individuals to maximize the utility purchasable with their money incomes. There is a genuine satisfaction that comes from the consumption of a com-

modity or service which adds to one's physical, mental, or social well-being. Doubtless, also, there is satisfaction of a sort to be had from outdoing in spending for the sake of display—else it would scarcely be so widely practiced. But it may well be questioned whether this is not, after all, a spurious kind of satisfaction, and recognized as such by the conspicuous consumer himself in his saner moments. For all save the very wealthy, of course, every lapse into conspicuous spending reduces the amount of money income available for expenditures of other kinds. And it would seem to follow that, for most people at least, indulgence in conspicuous spending must render impossible the attainment of individual maximization of utility in consumption.

Waste Through the Ignorance of Consumers. Professor Carver, in undertaking to prove that capitalism is preferable to socialism, argues that people as a rule buy more intelligently than they vote.[6] However that may be, the truth is that most people do not buy very intelligently. In some instances, as we noted in an earlier section, the fault is one of carelessness—a failure to apply to the spending of one's money income the information which one has or might readily get. In many cases, however, the purchaser is not to blame for his inability to judge the relative merits of consumers' goods. Doubtless the average man is more expert as producer than as consumer. He is a specialist in production, having devoted his time and energy to mastering a single trade or task, while as a consumer—or a buyer—he ventures into a hundred fields, in none of which can he hope to have very extensive information. The result is that in most of his buying he bargains at a distinct disadvantage, since he pits his meager knowledge against the skill and experience of the seller.

It is small wonder, then, that the consumer often fails to get the most for his money. We have already seen that price is not a safe guide to quality, nor for that matter is the appearance of a commodity to be relied upon. The piece of silk cloth that feels so strong and durable is probably weighted with sugar or lead; the oranges that appear so lusciously ripe may owe their sunny complexion to gas or dye; and the mattress that promises a lifetime of peaceful sleep may develop little hills and valleys within the year. Our ignorance of "true values" in the fields of food, clothing, cosmetics,

[6] T. N. Carver, *Essays in Social Justice*, Cambridge, Harvard University Press, 1922, pp. 113–125.

housefurnishings, automobiles, and other consumers' goods is most profound. As one writer puts it, "With no defense except a waning quality of common sense, the ultimate consumer makes his blundering way; a moth about a candle." [7]

However, the consumer is not wholly helpless, for there are several increasingly influential agencies that are working in his behalf. We are not now referring to such assistance as is rendered by the enforcement of federal and state legislation designed to discourage fraud and misrepresentation; or to such agencies as the Better Business Bureaus, which do something to tone down the extravagant claims of advertisers, and the "Good Housekeeping Institute," which tests and guarantees all articles advertised in *Good Housekeeping*, but declines to say which is the best among several competing brands. We have in mind, rather, Consumers' Research, Inc., and the Consumers Union of the United States, Inc.,[8] two non-profit organizations which undertake to provide their respective subscribers with accurate, unbiased information about many kinds of consumers' goods.

These "services" do not pretend to cover the field completely, but they are already sufficiently extensive to be of great assistance to the average consumer, and their data are being revised and added to continually. Many of the tests which form the basis of their reports are made in the laboratories of one or other of the two organizations, though some are conducted in outside laboratories. The information comes to the subscriber in the form of *comparative* lists, which classify specific brands of a commodity as *good, fair,* or *poor.* It goes further and tells which is the "best buy" so that the consumer learns not only what brands to avoid, but also—and this is of the utmost importance—which particular brand will give him the most for his money. Our publicly financed United States Bureau of Standards might do much to protect the consuming public from being imposed upon, by dedicating a part of its admirable facilities to the discovery and publication of the truth about consumers' goods that are used by millions of Americans. Indeed, it would help

[7] Stuart Chase and F. J. Schlink, *Your Money's Worth,* New York, The Macmillan Company, 1927, p. 41. The woeful ignorance of consumers is dealt with at length, also, in F. J. Schlink and Arthur Kallet, *100,000,000 Guinea Pigs,* New York, The Macmillan Company, 1933; and M. C. Phillips, *Skin Deep,* Washington, N. J., Consumers' Research, Inc., 1934.

[8] Consumers' Research, Inc., Washington, N. J., Consumers Union of the United States, Inc., 17 Union Square, New York 3, N. Y.

somewhat if the Bureau did nothing more than publish the results of the tests which it now makes for business men and corporations. So long as it fails to do either or both of these things, the consumer must continue to rely upon privately supported agencies, such as Consumers' Research and the Consumers Union, which appear to be performing a necessary social function—and performing it successfully in the face of considerable opposition from business men who find their disclosures somewhat embarrassing.

Waste Through Deceptive Advertising. Advertising has been, and will probably continue to be, one of the chief obstacles to the individual maximization of utility in consumption. There is no question that advertising may play a socially useful rôle in the creation of possession utility. But if, at any time, advertising subtracts from the sum total of utility in society, instead of adding to it, those who are responsible are clearly guilty of waste; and if advertising leads buyers astray and prevents them from maximizing utility, it may properly be condemned on the basis of contributing to waste in consumption.

Advertising may be getting more truthful (as its advocates frequently claim) or it may not, but in any case it still has a long way to go before the consumer can safely accept it at face value. Outright falsehood may be rare, but of unwarranted implication there is more than enough in many advertisements. The situation is interestingly described by an advertising publisher in a speech made to advertising men. He said, in part:

> Too many of our creators of advertising, it would seem, have forsaken the mansions of logic to wander capriciously in a weird new state—a state that can be described only by the coined word "Adnesia." Only in this strange state are cigarettes viewed as an aid to health; only here do kindly professors go about counseling mothers in the delicate matter of administering laxatives.
>
> Where, except in "Adnesia," could one reasonably expect to find Romance in a package of soap chips, or detour the divorce court by the simple expedient of changing to a new brand of tooth paste? And surely only one long-resident in this crazy state could have conceived the cockeyed notion of borrowing the testimony of dimpled and diminutive Shirley Temple to exploit a two-ton motor truck! There, indeed, is genius in its dizzy eminence.[9]

[9] "What Advertising Men Say About Advertising," *Special Bulletin 25*, Washington, N. J., Consumers' Research, Inc., October, 1936, p. 1.

A very mild instance, but an actual one, of poetic license in the realm of advertising was revealed by the Federal Trade Commission. In singing the praises of its razor blades—"Made of English Razor Steel"—a New York department store announced: "We went to Pennsylvania for a new secret-process, high-speed steel. In ingots, we took it to England to be rolled to a ribbon, because the British armorers roll steel with unbeatable accuracy. We brought the ribbon-reels back from England and had them cut into blade-shapes, then honed and stropped with more loving care than we've ever seen put into such a job." In fact, these blades were stock blades made by a New Jersey corporation, and not under supervision of the department store. The Federal Trade Commission ruled "that the respondent's false representations that it oversees each step in the manufacture of these blades tends to lead a substantial part of the public to attribute to them a quality not usually attributed to merchandise made for the trade generally."[10]

Even if we accept literally the statement of an experienced advertising man that "advertising copy during the past several years has been a bunch of blah, blah, bunk,"[11] the fact remains that advertising pays. That is to say, it pays the *seller*—whatever the effect upon the buyer may be—for it unquestionably stimulates sales. Indeed, a recent study made by a research specialist leads to the conclusion that in some cases advertising is more important than low prices, style, or quality, in selling women's, misses', and junior misses' dresses and sports wear.

Table 21 presents the significant conclusions of this study in convenient form. It shows that in selling women's dresses advertising proved to be 116 per cent as important as low price, 127 per cent as important as style, and 124 per cent as important as quality. In disposing of junior misses' dresses, the relative importance of advertising to low price, style, and quality was shown to be, respectively, 122 per cent, 193 per cent, and 223 per cent. If these figures have any validity at all, they suggest to the self-seeking business man that it is wiser to spend on advertising than on quality. What is said about a commodity is apparently more important to the purchaser than the quality of the commodity itself. This

[10] The case is cited in Consumers' Research *Bulletin*, Washington, N. J., Consumers' Research, Inc., March, 1937, p. 6.

[11] "What Advertising Men Say About Advertising," p. 6

TABLE 21. RELATIVE IMPORTANCE OF ADVERTISING AND OTHER MERCHANDISING FACTORS IN SELLING CLOTHING (IN PERCENTAGES)[a]

Commodity	Percentage Importance of Advertising to		
	Low Price	Style	Quality
Women's dresses	116	127	124
Misses' dresses	79	121	135
Junior misses' dresses	122	193	223
Sports wear	94	133	156
Average	103	143	159

[a] Source: *New York Herald Tribune*, July 21, 1936.

amounts, of course, almost to an invitation to market shoddy goods by means of intriguing sales talk, rather than sound goods through accurate, straightforward description. It would be childish to suppose that enterprisers never take advantage of a situation of this kind, and equally so to think that individual maximization of utility in consumption can be achieved until the situation is remedied.

CONSUMERS' COOPERATION

We have sketched briefly some of the obstacles that stand in the way of the attainment of individual maximization of utility in consumption. These and other difficulties experienced by consumers have led to the conclusion that consumers' goods might be purchased more advantageously if the job were done collectively instead of individually. One outcome of this conviction has been the organization of consumers' cooperative associations. The recent spread of the cooperative movement among consumers warrants a brief discussion of the aims and methods of consumers' cooperatives.

Rochdale Society of Equitable Pioneers. Consumers' cooperation had its beginning in Rochdale, England, in December, 1844, when twenty-eight weavers banded together into an organization through which they hoped to get more for their money than was possible when they bought as individuals from retail stores. With a total capital of about $150, the Rochdale Society of Equitable Pioneers bought a small stock of flour, oatmeal, butter, and sugar, with which they began their undertaking of squeezing out the middleman's

profits, and thus increasing the utility obtainable from the spending of their wages. By the end of the year 1845, they had seventy-five members, a paid-up capital of $900, and a record of having transacted $3500 worth of business in a twelve-months period. In 1934, this same Rochdale Society had 44,000 members, nearly $3,000,000 in capital, and did a business totaling $3,285,000. From 1844 to 1934, its total volume of business was $150,000,000, and it distributed among its members "surplus-savings" to the amount of $20,000,000.[12]

"The basic principles adopted by these famous weavers to solve their own purchasing problems were eightfold: Their consumer cooperative would sell goods at prevailing local prices; a fixed rate of interest would be paid upon capital invested; profits,[13] after payment of all expenses including interest, should be distributed in proportion to member purchases; no credit would be granted; both sexes were to have equality in membership rights; each member was to have just one vote; regular meetings of members were to be held; and accounts were to be properly kept and audited." [14]

The Goal and Method of Consumers' Cooperation. The substantial degree of success achieved by the Rochdale Pioneers is perhaps less surprising than the fact that their fundamental principles, as originally outlined, have endured for almost a century and even today form the basis of most of the consumers' cooperatives throughout the world. According to the Cooperative League, the national federation of consumers' cooperative associations of the United States, present-day consumers' cooperation is based upon four great principles, upon which will eventually be built a Cooperative Economic Society. "Its principle of open membership will give us economic brotherhood. Its principle of 'one person, one vote' will give us economic democracy. Its principle of 'minimum interest on shares' will give us security instead of speculation. Its principle of 'distributing the surplus savings as dividends on the basis of patronage' will give us just distribution of wealth. These are the four corner stones of a Cooperative Economic Society."

[12] J. P. Warbasse, *Cooperative Democracy,* New York, Harper & Brothers, 3rd ed., 1936, pp. 26–29. This book is frequently referred to as "the bible of the consumers' movement."

[13] Defined by the cooperatives themselves as savings returned to the consumer, and not profits—a distinction affecting the application of income taxes.

[14] *The Index,* New York, The New York Trust Company, December, 1936, p. 234.

From the tone of this statement, it is evident that consumers' cooperation is expected by its more ardent advocates to accomplish great things in times to come. To some, indeed, it appears in the nature of a crusade which is to save the world from communism and fascism, when capitalism shall have spent its force. But to the rank and file it means chiefly, and will doubtless long continue to mean, an agency which enables consumers to circumvent the retailer and effect a saving of, say, 10 per cent on many of their purchases. In the matter of quality, too, the cooperative can render a distinct service to its members, and one which will be more fully appreciated when its importance is more generally recognized. The quality of the goods that are sold cooperatively is usually high, but in any event the commodities are honestly described and fairly priced. Many of these products are manufactured to specifications laid down by the cooperators. For instance, it is now possible to buy cooperatively "a white floating household and bath soap, equal in quality to the most highly advertised 'floating' soap on the market," and at a price roughly one-third less than that charged in grocery stores for soap of equal quality sold under a copyrighted name. Here is an example of cooperation providing both low price and assured quality; and in many cases the latter may be even more important than the former.

Ordinarily, consumers' cooperatives are organized on a very small scale, and expand gradually as their service attracts new members. In urban and suburban communities they often start as cooperative buying clubs, organized by white-collar or professional people. The commodities handled may include groceries, fruits and vegetables, dairy and poultry products, dentifrices and simple cosmetics made up to formulae, gasoline, and a variety of other articles used by the average family. In rural sections of the country, such farm supplies as fertilizers, seeds, feed for cattle and poultry, binder wire and twine, spraying materials, paint, tires, and lubricating oils, are often handled more extensively than the usual household goods. It is estimated that there are in the United States three times as many cooperative associations handling petroleum products and stock feed as there are handling groceries.[15]

[15] *Fortune*, March, 1937, pp. 142, 144. The article, "Consumer Cooperatives," in that issue of *Fortune* was pronounced by the Cooperative League "the best and most recent picture of the current development" of the movement. Many of the data here presented were borrowed from this article.

The principle of cooperation has also been applied to the sale of electrical power, the extension of credit (through credit unions), the writing of insurance, and various other services. An interesting development is "a chain of eleven cooperative cafeterias in New York City which has been operated successfully for fifteen years by Consumers' Cooperative Services. The chain has added two new units during the depression, while paying its employees 30 per cent more than the N.R.A. minimum wages."[16]

Retail, Wholesale, and Producing Consumers' Cooperatives. There were approximately 4300 *retail* cooperative associations in this country in 1944, with a total membership of more than 1½ million persons. In that year, these retail cooperatives did a gross business of $557,000,000, an increase of 31 per cent over 1935.[17] It is authoritatively estimated that the retail consumers' cooperatives of thirty-three countries sold nearly two billion dollars' worth of goods in 1935.[18]

Retail cooperatives buy their stocks of goods as advantageously as possible, striving to get high-quality goods at low prices. However, since the individual retail cooperatives are often too small to bargain successfully with producers, they have set up in the United States twenty-six large regional *wholesale* cooperatives, which buy from the factories and sell to the retail associations, to which they rebate the wholesale profits.[19] These wholesale cooperatives enter into contracts with manufacturers, packers, and canners. The contracts are for staple goods, made to laboratory specifications. In this way the retail cooperatives are enabled, as we have already suggested, to supply their members with goods of a known quality.

One of the large wholesale associations is National Cooperatives, Inc., of Chicago, which makes contracts for bulk products such as oil, binder twine, feed and fertilizers, and did $25,000,000 worth of business in 1935.[20] The Cooperative Grange League Federation Exchange, Inc., of Ithaca, New York, is said to have done a $24,000,-

[16] *New Republic*, May 6, 1936, p. 360.

[17] Other cooperatives for consumers in 1944 were the following: 850 electricity associations, with 1,149,700 members, doing a business estimated at $60,000,000 for the year; 9000 credit unions, 3,027,700 members, $212,000,000 worth of business; 2000 insurance associations, 10,510,000 members, $190,000,000 worth of business.

[18] *Consumers' Cooperation Throughout the World in 1935*, Washington, United States Bureau of Labor Statistics, Serial No. R 499, p. 4.

[19] *Fortune*, March, 1937, p. 133.

[20] *Ibid.*, p. 140.

000 business in feed, seeds, fertilizers, and other supplies during the fiscal year ending June 30, 1935. Looking at the volume of business transacted by wholesale cooperatives throughout the world, we find that more than a billion dollars' worth of goods were handled by the cooperative wholesale associations of twenty-eight countries in the year 1935.[21]

"When consumer cooperatives reach a certain stage in their development, they tend to work back toward *producing* or *processing* the goods they sell to their members."[22] However, very little has been done in this field in the United States, where practically the only examples of cooperative production are the manufacture of bakery goods by one wholesale association, the manufacture of feed by two organizations, and the compounding of motor oils by three others.[23] The goods manufactured by the wholesale cooperative associations of sixteen leading countries had a total value of approximately $270,000,000 in 1935.[23]

Consumers' Cooperation in Other Countries. The cooperative movement in general has met with greater success in Europe than in the United States; and so, too, has that phase of the movement with which we are now dealing. England, the home of the original Rochdale Pioneers, remains the outstanding example of consumers' cooperation in number of members and volume of business transacted. About one-half of the families of England belong to cooperatives, and the cooperative stores there did about one-eighth of the total retail business of the country in 1935, with sales amounting to $1,081,000,000. The English Cooperative Wholesale Society, which was formed in 1863 and now consists of more than a thousand societies, "is the biggest distributing organization in the British Empire. It has a $700,000,000 bank, a $100,000,000 insurance company. It owns its own steamships, coal mines, olive groves, and, with the Scottish Wholesale, the world's largest tea plantations. It is the No. 1 buyer of Canadian wheat, the No. 1 British miller, No. 1 shoemaker, and second only to Lever Brothers in soapmaking. Its factories turn out everything from corsets to oil cake, from automobiles to saddlery."[24] The "surplus-savings" of the English consumer cooperatives in 1934 amounted to about $125,000,000.

[21] *Consumers' Cooperation Throughout the World in 1935*, p. 10.
[22] *Fortune*, March, 1937, p. 137.
[23] *Consumers' Cooperation Throughout the World in 1935*, p. 14.
[24] *Time*, July 13, 1936, pp. 61, 62.

We shall not be able to examine in detail the status of consumers' cooperation in each of the countries in which it has gained a foothold. We may, however, present a few significant figures. Despite the efforts of the fascist dictatorships to destroy the consumers' cooperatives, these associations in 1935 transacted business amounting to $157,000,000 in Germany and $62,000,000 in Italy. The amount of business done in that year by consumers' cooperatives in other countries is indicated by the following figures: France, $92,000,000; Finland, $84,000,000; Denmark, $76,000,000; Switzerland, $63,000,000; Czechoslovakia, $52,000,000; Norway, $35,000,000; Australia, $31,000,000; and the Netherlands, $26,000,000. As we have already noted, the total 1935 sales of consumers' cooperatives in thirty-three countries totaled nearly two billion dollars.[25] In several countries that are particularly well served by cooperatives, the portion of the total retail trade handled by the cooperative stores is approximately as follows: Finland, 25 per cent; England, 15 per cent; Denmark, 15 per cent; and Sweden, 10 per cent. A comparable figure for the United States is 1.3 per cent.[26]

The Future of Consumers' Cooperation. We have said little by way of appraisal of the consumers' cooperative movement, for it has seemed best to allow the facts to speak for themselves. Nor shall we undertake to predict the future of consumers' cooperation, since it is scarcely the function of the economist to indulge in prognostication. It can do no harm, however, to note the observation of Roger Babson, the business men's counselor, that "merchants who laugh off these consumers' crusades are sitting on dynamite"; and the following comment from *Printers' Ink*, a trade journal: "If co-ops are to be viewed with alarm as poaching on the preserves of private business, there is plenty of room for alarm." Further manifestations of recent interest in consumers' cooperation have been the attention given the movement by the Roosevelt administration, which sent a commission to Europe to study the operation of consumers' societies there; a gift of $1,000,000, made by the late Edward A. Filene, the Boston merchant, to assist in the establishment of cooperative department stores; and the creation, in 1944, of a Department of Consumers' Cooperation by the American Federation of Labor, to aid local unions in setting up cooperatives in collaboration with the Cooperative League of the United States.

[25] *Consumers' Cooperation Throughout the World in 1935*, pp. 4, 5.
[26] *Fortune*, March, 1937, p. 139.

On the other side of the picture is the stubborn fact that the movement has been slow to catch on in the United States. The half-billion-dollar business transacted by consumers' cooperatives in 1936 constituted only 1.3 per cent of our total retail trade; and three-fourths of the goods these cooperative stores sold to their members were not *consumers' goods,* in the strict sense of the term, but seeds, fertilizers, stock and poultry feed, and other *producers' goods* needed in carrying on the business of farming in our great agricultural states. There can be little doubt that the recent spurt taken by consumers' cooperation in the United States resulted, at least in part, from the hardships suffered in the post-1929 depression. "Years of general prosperity are usually lean years as regards the spread of the cooperative philosophy. That philosophy is primarily an economic one, making its appeal first to the financial self-interest of the individual, by the possibilities of savings that it offers. When times are good, when wages are high and money is plentiful, such small savings as the cooperative society offers make little appeal to the average wage earner in this country, especially considering the effort involved in obtaining these savings." [27]

Consumers' cooperation has demonstrated that it can help the consumer to get low prices and high quality, and thus increase the utility obtainable through the expenditure of his money income. It has shown, through its wide spread in many European countries, that it is capable of attaining formidable proportions under favorable conditions. Whether the economic conditions in America and the temper of the people will prove suitable for its continued and extensive growth, we do not pretend to know; and on this point we decline to hazard a guess.

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1. Define "waste in consumption."
2. What did Ruskin mean by "illth"?
3. Professor Hobson says that "everyone will admit that many sorts of marketable goods and services are injurious alike to the individuals who consume them and to society." Name as many items of this kind as you can.
4. If society should decide to prohibit the production of "illth," what definition of this term can you suggest for deciding whether a specific commodity should or should not be outlawed?

[27] "Organization and Management of Consumers' Cooperative Associations and Clubs," *Bulletin No. 598,* Washington, United States Bureau of Labor Statistics, p. 1.

5. "Most good things are capable of being turned to bad uses." What is the significance of this statement in connection with maximizing utility in consumption?
6. "Waste in consumption is closely related to economic inequality." Explain.
7. What justification is there for saying that progressive taxation is based upon the Law of Diminishing Utility?
8. How might the provision of public relief during the depression be construed as a move in the direction of greater equality in the distribution of income?
9. The desire for distinction leads almost inevitably to waste in consumption. Explain.
10. What is the significance of the statement that "there is a hierarchy in the realm of conspicuous spenders"?
11. Give examples of the failure to maximize utility in consumption because of carelessness in the purchase and use of goods.
12. It is commonly assumed that high price means high quality, since "you get just about what you pay for." Argue that this notion is or is not correct.
13. Since some people delight in outdoing others in displaying their costly possessions, on what ground may it fairly be said that indulgence in conspicuous consumption involves waste in consumption?
14. What evidence is there that the ignorance of buyers leads to waste in consumption?
15. In what respects is the service of Consumers' Research and the Consumers Union more useful to consumers than that of the Good Housekeeping Institute?
16. State your views on the probability of a customer making a "best buy" among a half-dozen brands of a given good (say, soap) offered for sale by a department store. Explain how Consumers' Research or the Consumers Union might aid in making a sound choice.
17. Do you regard present-day advertising as an aid or a hindrance to the wise purchase of consumers' goods? Why?
18. Sketch the origin and growth of the Rochdale Society of Equitable Pioneers.
19. On what basic principles was the Rochdale Society founded?
20. What is the goal of consumers' cooperation, as set forth by the Cooperative League?
21. What varieties of commodities are handled by (a) urban and (b) rural consumers' cooperatives?
22. Describe the nature and extent of *retail*, *wholesale*, and *producing* consumers' cooperatives.
23. Describe the achievements of consumers' cooperation in England.
24. In what other countries, and to what extent, has the consumers' cooperative movement made progress?
25. What is your feeling about the future of consumers' cooperation in the United States? Upon what facts do you base your opinion?

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18. Economic Inequality: Extent and Consequences

In the present chapter and the one which follows, we look into the distribution of the national income among individuals, families, and groups, with special reference to the problem of economic inequality.

The existence of inequality of this kind is apparent even to the least observant. In most instances, perhaps, this knowledge comes to a person through observing that his economic status does not compare favorably with that of certain other persons. Nearly every man is painfully aware, at one time or another, that his dwelling, his automobile, or his theater seats are inferior to those of some other members of society, and readily understands, in most instances, that the fault lies in the leanness of his purse—that is, in the inadequacy of his money income. Relatively few, however, realize the extent of inequalities in income in the great industrial nations, and still fewer give serious thought to the consequences of these inequalities, which gravely affect many phases of human life.

The truth is that economic inequality, as it exists in the United States today, means poverty for many in this land of plenty, and makes a grim joke of the American tradition of equality of opportunity. Inequality breeds inequality, and thus perpetuates a condition that keeps some persons from attaining the full development of their abilities, and from competing effectively with others of equal talents whom fortune has cast in happier rôles. The problem of economic insecurity, as we see it, will be solved only when society has insured equality of opportunity for all its members, so far as this can be accomplished through the removal of artificial obstacles to the full development and utilization of personal capacities.

Some Data on Distribution of Income

Statistics on the distribution of income in the United States, like so many kinds of economics statistics, are available only in fragmentary form. We shall have to manage with figures which, though admittedly unsatisfactory in some respects, serve nevertheless to indicate the major groups of incomes in this country, ranging from those too small to buy even a "health and decency" standard of living to others so huge as to encourage the most extravagant spending. The most recent large-scale study of American incomes is the analysis made by the National Resources Committee of data gathered in a nation-wide survey of consumer purchases.[1] The "sample" covered some 300,000 families and a much smaller number of single men and women, and included incomes of all kinds. From these data, estimates were made of the incomes received, in the twelve-month period from July, 1935, to June, 1936, by the country's 29 million families of two or more persons and the 10 million single persons living alone or as lodgers.

These estimates, which are presented in Table 22, give a fair picture of the extent of economic inequality in a mid-depression year when production in this country was about 75 per cent as great as in the "normal" year of 1926. Though the amounts of income are different in "good" and "bad" years, the "distribution spread" is not radically different (as may be seen by comparing statistics for 1918, 1929, and 1935–36), and the existence of inequality would be apparent from the study of income figures for any year. If the reader should question the desirability of considering "families" and

[1] National Resources Committee, *Consumer Incomes in the United States: Their Distribution in 1935–36,* Washington, Government Printing Office, 1938.

A less fully detailed estimate of incomes in the United States, for the highly abnormal year of 1945 (*Report for the Business Executive,* July 25, 1946, p. 4), is given below:

Income Distribution in the United States, 1945

	No. of Families	Per Cent of Total	Income in Billions	Per Cent of Total (Income)
Under $1000	9.2 millions	20	$ 4 9	4
$1000–$2000	12.4	27	19.4	16
$2000–$3000	10.6	23	27.8	23
$3000–$4000	6.9	15	25 4	21
$4000–$5000	3.2	7	14.5	12
$5000–$7500	2.3	5	13.3	11
$7500 and over	1.4	3	15.7	13
	46.0	100	$121.0	100

TABLE 22. DISTRIBUTION OF FAMILIES AND SINGLE INDIVIDUALS AND OF AGGREGATE INCOME RECEIVED, BY INCOME LEVEL, 1935–36 [a]

Income Level	Families and Single Individuals			Aggregate Income		
	Number	Per Cent at Each Level	Cumulative Per Cent	Amount (in thousands)	Per Cent at Each Level	Cumulative Per Cent
Under $250	2,123,534	5.38	5.38	$ 294,138	0.50	0.50
$250–$500	4,587,377	11.63	17.01	1,767,363	2.98	3.48
$500–$750	5,771,960	14.63	31.64	3,615,653	6.10	9.58
$750–$1,000	5,876,078	14.90	46.54	5,129,506	8.65	18.23
$1,000–$1,250	4,990,995	12.65	59.19	5,589,111	9.42	27.65
$1,250–$1,500	3,743,428	9.49	68.68	5,109,112	8.62	36.27
$1,500–$1,750	2,889,904	7.32	76.00	4,660,793	7.87	44.14
$1,750–$2,000	2,296,022	5.82	81.82	4,214,203	7.11	51.25
$2,000–$2,250	1,704,535	4.32	86.14	3,602,861	6.08	57.33
$2,250–$2,500	1,254,076	3.18	89.32	2,968,932	5.01	62.34
$2,500–$3,000	1,475,474	3.74	93.06	4,004,774	6.76	69.10
$3,000–$3,500	851,919	2.16	95.22	2,735,487	4.62	73.72
$3,500–$4,000	502,159	1.27	96.49	1,863,384	3.14	76.86
$4,000–$4,500	286,053	.72	97.21	1,202,826	2.03	78.89
$4,500–$5,000	178,138	.45	97.66	841,766	1.42	80.31
$5,000–$7,500	380,266	.96	98.62	2,244,406	3.79	84.10
$7,500–$10,000	215,642	.55	99.17	1,847,820	3.12	87.22
$10,000–$15,000	152,682	.39	99.56	1,746,925	2.95	90.17
$15,000–$20,000	67,923	.17	99.73	1,174,574	1.98	92.15
$20,000–$25,000	39,825	.10	99.83	889,114	1.50	93.65
$25,000–$30,000	25,583	.06	99.89	720,268	1.22	94.87
$30,000–$40,000	17,959	.05	99.94	641,272	1.08	95.95
$40,000–$50,000	8,340	.02	99.96	390,311	.66	96.61
$50,000–$100,000	13,041	.03	99.99	908,485	1.53	98.14
$100,000–$250,000	4,144	.01	100.00	539,006	.91	99.05
$250,000–$500,000	916	[b]	.....	264,498	.45	99.50
$500,000–$1,000,000	240	[b]	...	134,803	.23	99.73
$1,000,000 and over	87	[b]	..	157,237	.27	100.00
All levels	39,458,300	100.00	..	$59,258,628	100.00	....

[a] Source: *Study of Consumer Purchases,* Bureau of Home Economics.
[b] Less than 0.005 of one per cent.

"single individuals" together, he will be interested in the Committee's comment in this connection: "Such treatment is justified by the lack of a sharp distinction between the two groups from the standpoint of the receipt and use of income. The diversity among the consumer units that make up the 29 million families is fully as great as that between families as a group and single individuals. An income of $1000 a year means, to be sure, one thing to a single man or woman and another to an average family of four. But it also has quite different meanings to the family of two persons and to the family of eight. These two major groups of consumer units can therefore be combined, at each income level, to show . . . income distribution for the nation as a whole." [2]

This study by the National Resources Committee indicates that the most prosperous 1 per cent of the income receivers got more than 13 per cent of the total income, the most prosperous 3 per cent got 21 per cent, and the most prosperous 10 per cent got more than 36 per cent. It shows, also, that 87 per cent of the income receivers in this country in 1935–36 had incomes of less than $2500 for the year, 65 per cent had incomes of less than $1500, 42 per cent had less than $1000, and 14 per cent less than $500.

A further set of figures, to which we shall have occasion to refer in the next chapter, is given in Table 23.[3] We see here that the larger

TABLE 23. PERCENTAGE DISTRIBUTION OF TOTAL INCOMES IN INCOME TAX RETURNS FOR 1936, BY NET INCOME CLASSES, SHOWING DISTRIBUTION BETWEEN INCOMES FROM WAGES AND SALARIES AND FROM PROPERTY [a]

Net Income Classes (thousands of dollars)	Percentage from Wages and Salaries	Percentage from Property
Under 5 (estimated)	70.22	29.79
5– 10	48.72	51.28
10– 25	36.37	63.63
25– 50	26.24	73.76
50– 100	19.29	80.71
100– 150	15.08	84.92
150– 300	9.97	90.03
300– 500	5.96	94.04
500–1000	2.36	97.64
1000 and over	1.09	98.91

[a] Source: United States Treasury Department, Bureau of Internal Revenue.

[2] *Ibid.*, pp. 4, 5.

[3] *Statistical Abstract of the United States, 1939*, p. 188.

the income, the smaller is the proportion of the income that comes from wages and salaries, and the larger the proportion from property. For example, almost 49 per cent of the incomes ranging from \$5000 to \$10,000 a year are made up of wages and salaries, while slightly more than 1 per cent of the very largest incomes (1 million dollars and over) represent payment for personal services. Wages and salaries, then, form only a slight part of the incomes of the very wealthy, but are increasingly important as we move down the income scale, and comprise practically the whole income of the great mass of the gainfully employed. Returns from the ownership of property, on the other hand, are of almost no significance in the incomes of the "working classes," but provide more than one-half of the total incomes of all persons receiving \$5000 or more annually, and an overwhelming proportion of the incomes of the very wealthy. Thus we see that there are great inequalities in the distribution of *wealth*, as well as in the distribution of *income*. However, we should always bear in mind, when considering economic inequality, that our system of steeply graduated federal income taxes takes from those in the upper income brackets a large percentage of their total incomes, and our federal estate tax and state inheritance taxes do a good deal by way of redistributing huge accumulations of wealth, as is shown in Chapters 10 and 17.

The Consequences of Economic Inequality

But of what significance are these inequalities in the distribution of income? Is there any evidence to show that they result in hardship or injustice? May they not, indeed, be beneficial rather than harmful to society? It is questions such as these that we shall now undertake to answer, by attempting to interpret economic inequality in terms of standards of living, economic security, educational opportunity, legal justice, and the control of government.

Economic Inequality and Standards of Living. In the present day and age, no one is likely to dispute the statement that there is a close relationship between money incomes and standards of living. Indeed, we may say that a man's standard of living consists of the total economic goods—commodities and services—that he can buy with his money income. The data on income that we have just examined show clearly that there are wide variations in incomes in this country, and it takes but half an eye to see that standards of living in the United States and other countries vary almost as

greatly as incomes. It is a far cry from the scanty diet of the poor to the overloaded tables of the rich, from the thin soles and threadbare clothing of the many to the fur coats and diamonds of the few, from the dingy rooms of most of our wage earners to the palatial residences of our multimillionaires. It is small wonder that we find pale, scrawny children on the East Side of New York, and ruddy, plump boys and girls on suburban estates. We are speaking here of great extremes, to be sure, but between these extremes are gradations in standards of living that run the whole gamut from genuine privation to satiety. It is evident, then, that with inequality in incomes goes inequality in standards of living.

Many attempts have been made to determine the amount of income that is necessary to provide for the basic needs of a family of five. Such an estimate, which was called a "Minimum Health and Decency Budget," was published by the United States Bureau of Labor Statistics in 1919,[4] and has been brought up to 1940 by the Labor Research Association. The budget includes the following items:

1. Nourishing food.
2. Houses in low-rent neighborhoods and with the smallest possible number of rooms consistent with decency (about four rooms and a bath).
3. The upkeep of household equipment, but with no provision for the purchase of additional furniture.
4. Clothing sufficient for warmth, but with no further regard for style than would permit one to appear in public without slovenliness or loss of self-respect.
5. Services of doctor, dentist, and oculist, $80; amusement and recreation, $20; union dues, $10; church and religious organizations, $13; incidentals, $52.

It should be borne in mind that this is a *minimum* budget, and one which, according to the Bureau of Labor Statistics, "does not include many comforts which should be included in a proper 'American Standard of Living.'" The Bureau found that this standard of living could be purchased in Washington, D. C., in 1919, for $2262.47. The Labor Research Association estimated the budget, in 1940, as costing from a minimum of $1770 in Reading, Pa., to a

[4] *Monthly Labor Review*, December, 1919, pp. 22–29.

maximum of $2262 in San Francisco, Cal., with an average cost of $1982 for ten American cities. In 1935–36 (the period to which the income figures in Table 22 apply), the average cost of this budget in the country as a whole was $1911, or slightly less than in 1940.

On the strength of these figures, it might seem that no total income which fell below $1770 in 1935–36 could be considered a "living wage," since that amount was the *lowest* cost of the budget specified by the government as representing the bottom level of health and decency. But this would be true only if every income were spent on a family of five or more persons, and this is clearly not the case, for 10 million of the incomes in Table 22 are those of single individuals. The National Resources Committee throws additional light on the situation by isolating and analyzing the *family* incomes. This analysis shows that the least prosperous 21 million families (or 72.60 per cent of the total) had incomes of $1750 or less, that the least prosperous 16 million families (54.88 per cent) had total incomes of $1250 or less, and the least prosperous 7 million families (27.13 per cent) had total incomes of $750 or less.

It would be incorrect to suggest that *all* of these 21 million families were compelled to live below the standard of health and decency. Some of them doubtless consisted of so few persons that their standard was well above the poverty level. But there were unquestionably many families of five or more persons (and some considerably larger than five) that had less than $1750 income apiece, and in instances of this kind there is real cause for apprehension and need for a remedy. Especially desperate was the situation of the 16 million families with annual incomes of less than $1250 each and the 7 million of these which had less than $750 for the year.

As we have already noted, these 1935–36 figures relate to a period of depression, when the national income was about 25 per cent lower than in the prosperous year of 1929. But the story they tell us is essentially the same as is told for 1918 by the detailed data that are available for that year of excellent business. And the same general thesis—that millions of families in the United States are never above the "health and decency" level of earnings—is confirmed by an examination of incomes in the boom year of 1943. In that year of enormous production, manpower shortages, and unusually high wages in many industries, nearly 15 million, or 36.6 per cent of our "consumer units" (families or individuals) had $1750 or less to

spend.[5] In that year also, the Bureau of Labor Statistics found that the average cost, in thirty-three cities in the United States, of a "maintenance level" family budget which "does not approach the content of what may be considered a satisfactory American standard of living" was $1768.[6]

The lack of exact data about these unfortunate members of society must not be allowed to blind us to the fact that poverty has existed and still exists in the United States. "Poverty," says Dr. Robert W. Kelso, "is that condition of living in which the individual, whether from lack of means or the failure to apply them, consistently fails to maintain himself, and those properly dependent upon him, at a plane of living high enough to insure continuous bodily and mental fitness to carry on permanently in his occupation and locality; and which allows him and them to live and function in their community with decency and self-respect." With this concept of poverty in mind, Dr. Kelso reaches the conclusion "that the unskilled laborers of America live in poverty; and that of those who work with their hands but are nevertheless skilled, from a third to a half possess [under our present social arrangements] neither the means nor the potentiality for the maintenance of a minimum standard of social competency."

In addition to the study of the National Resources Committee, we may mention conclusions reached in other surveys of family incomes. In 1918, the United States Bureau of Labor Statistics studied the incomes of more than 12,000 families (average size, 4.9 persons per family) in 92 localities of 43 states, and discovered that the average *family income* was $1513, or $700 less than the Bureau's health and decency budget in 1919, when general prices were substantially the same as in 1918.[7] A study of 100 families in Muncie, Indiana, in 1924, revealed the fact that the *total family income* of 74 of these families was below the budget estimate of the Bureau of Labor Statistics.[8] An inquiry into the incomes of 467 families of unskilled workers in Chicago, in 1924, showed that slightly more than one-half of these families were able, *with income from all sources*, to meet the Chicago Standard Budget for Dependent Families,

[5] *The Economic Almanac, 1945–46,* New York, National Industrial Conference Board, 1945, p. 81.

[6] *Labor Fact Book 7,* New York, International Publishers, 1945, p. 128.

[7] *Monthly Labor Review,* December, 1919, p. 41.

[8] Robert and Helen M. Lynd, *Middletown,* New York, Harcourt, Brace & Company, Inc., 1929, p. 85.

placed at $1548.84 *over and above rent.*[9] A survey of Philadelphia family incomes, made in 1928 under the auspices of the *Public Ledger* of that city, indicated that "50 per cent of the families have an income of less than $2000 yearly." [10] A study of the incomes of 536 working-class families, conducted by the New York State Department of Labor, showed that "half of the families had an income which was less than the amount necessary to maintain a standard of living at a minimum of decent subsistence for a family of five." [11] Finally, there is the estimate of the Brookings Institution, to the effect that about 12 million families in the United States, or more than 42 per cent of the total, had family incomes of less than $1500 each in 1929.[12] These scattered investigations, and others leading to similar conclusions, are sufficient proof that poverty does exist in this country, though to what extent it is impossible to say with any degree of accuracy or assurance.

If these total family earnings are at all representative of the incomes of large numbers of the people of the country—and we believe they are—it follows that there is widespread poverty in this richest of all nations. But is this poverty the result of inequality of distribution, or does it arise, rather, from the fact that our national income is not large enough to provide a satisfactory standard of living for the country as a whole? The answer to this question may be found in the *per capita* income of the United States. If we start with a national annual income of 90 billion dollars, and deduct 15 billions (our estimated annual savings in pre-depression 1929) for additions to industrial equipment, we have left some 75 billion dollars available for the purchase of consumers' goods over a twelve-month period. If production did not decline under a régime of strict equality, we could divide this amount on a per capita basis, giving $625 to every man, woman, and child, or a total of $3125 for a family of five. Though we do not advocate complete equality of incomes, either for all members of society or for all engaged in economic activities, we believe that these figures indicate that poverty is attributable to our system of distribution and not to a shortage of

[9] Leila Houghteling, *The Income and Standard of Living of Unskilled Laborers in Chicago*, Chicago, University of Chicago Press, 1927, p. 130.

[10] *Philadelphia*, Chamber of Commerce, Philadelphia, January, 1929, p. 14.

[11] Stuart Chase, *Prosperity: Fact or Myth?*, New York, Albert and Charles Boni, Inc., 1929, pp. 86, 87.

[12] Maurice Leven, Harold G. Moulton, and Clark Warburton, *America's Capacity to Consume*, Washington, Brookings Institution, 1934, p. 55.

economic goods. An allowance of $3125 would seem appallingly low to a considerable fraction of our people, but it would raise materially the standards of living of the rank and file, and would unquestionably convert the United States into a country in which poverty was virtually unknown, if the cost of living remained unchanged. And if we should find it possible to produce as large a national income in time of peace as in wartime (that is to say, 150 billion dollars' worth of usable goods), it is obvious that the standard of living could be raised to hitherto unheard-of heights.

In an earlier chapter[13] we showed that inequalities in wealth and income lead to conspicuous consumption, and argued that a move in the direction of equality would tend to reduce waste of this kind. This is almost necessarily the case, for there would be but little point to an attempt to "show off" through competitive spending in a society in which incomes were wholly, or even approximately, equal. The attractiveness of conspicuous consumption lies chiefly in the ability to spend on a scale so grand that at least some other members of society are outshone. In a society in which incomes range from hundreds to millions, there is likely to be a very large number of "income classes," with each class striving to outdo the class immediately beneath it in the scale. But in a society in which incomes were equal, there would be little incentive, as well as little opportunity, for conspicuous spending. The fact that any family, by virtue of the equality of money incomes, could match the spending of any other family would detract immensely from the zest of the game and would, in all probability, sound the death knell of this silliest and most wasteful of all types of display.

In dealing with problems in consumption,[14] we undertook to distinguish between individual and social waste of this kind. We suggested that there is *individual waste in consumption,* whenever an individual, for any reason whatsoever, fails to secure the maximum of utility through the expenditure of his money income, and *social waste in consumption* whenever society fails to get the maximum of total utility from whatever goods are produced by society as a whole. We indicated further, that, in the presence of considerable differences in individual incomes, the attempts of individuals to maximize the utility to be derived from their money incomes may easily lead to social waste in consumption. Indeed, it is scarcely too much to say that the elimination of both individual

[13] Chap. 17. [14] Pp. 458–464.

and social waste in consumption can be attained, if at all, only in a society in which incomes are substantially equal. An acceptance of the Law of Diminishing Utility leads to the conclusion that, in all probability, the greatest possible social satisfaction is dependent upon approximate equality of money incomes. If, then, we should ever achieve such an equality, we might expect also to achieve the maximum social satisfaction; and it is conceivable that we might have, at the same time, the maximization of satisfaction from the expenditure of individual money incomes—in which case we should have eliminated waste in consumption!

It is a commonplace that "money talks," and it appears to talk loudest and most effectively when it is concentrated in considerable quantities. The "demand" for an article consists, of course, not only of desire for the good but also of purchasing power to back up that desire. As a consequence of this fact, the things that rich men want are more likely to be produced than the things that poor men need. If a Philadelphia millionaire wants a \$5,000,000 private yacht while workingmen need small, sanitary houses, the yacht is built and the workers and their families continue to live in tenements. Whenever agents of production are diverted from the making of necessities and used in the manufacture of luxuries, there is a tendency for the prices of necessities to rise, so that the person of small income gets less for his money than he would have been able to get if luxuries were not produced. Obviously, there would be no \$5,000,000 private yachts,[15] \$1,000,000 "coming out" parties,[16] \$60,000 sable coats,[17] or \$2000 silk hosiery,[18] if incomes were anything like equal; and as a consequence the plain, substantial goods that minister to the needs of the many

[15] The *Savarona,* built for Mrs. Richard M. Cadwallader of Philadelphia in 1931, was said to have cost this sum. This "finest private sailing vessel the world has ever seen" was manned by a crew of seventy. (*New York Times,* July 19, 1931, and October 11, 1931.)

[16] "Auditors of the Mayflower Hotel, in Washington, report that the famous party which Mr. H. L. Doherty, of Cities Service, threw there in honor of his adopted daughter, cost him a cool million dollars, or, in other words, \$500 for each of his 2000 guests." (*New Republic,* January 7, 1931.)

[17] *The New York Tribune,* of September 25, 1921, listed some of the personal possessions of Mrs. Edward Henry Smith Wilkinson, of Nottingham, England, including \$3,400,000 worth of jewelry, \$128,000 worth of gowns, \$64,000 worth of hats, and a \$60,000 sable wrap. (Cited in Stuart Chase, *The Tragedy of Waste,* New York, The Macmillan Company, 1926, p. 90.)

[18] In the Philadelphia *Bulletin,* of October 5, 1931, appeared a picture of "the most expensive hosiery in the world." They were made "of sheerest chiffon, ornamented with diamonds set in pendants of platinum," and cost \$2000 per pair.

would be produced in larger quantity and sold at smaller prices than at present.[19] Furthermore, there can be no doubt that many poorly paid persons now spend part of their incomes for the sake of keeping up appearances, and under existing circumstances such spending may be necessary for the maintenance of self-respect. But an equality, or near-equality, of incomes would eliminate most of the shining examples of ostentatious display, and would make feasible the expenditure of incomes for solid comforts instead of the tawdry jimcracks that class conventions make necessary today.

Economic Inequality and Economic Security. A study of present-day economic life shows that fluctuations in business activity lead to instability of income that affects, to a greater or lesser degree, the members of all of the many income groups found in our economic organization. However, it should be clear, from the chapters dealing with economic insecurity, that variations in income do not affect all groups in the same manner or to the same extent. When industrial depression forces a successful manufacturer to close down his plant temporarily, his manner of living and that of his family are not, as a rule, substantially altered. He may have to dispense with one or two of his cars, to get along with fewer servants, and perhaps to take his family on a relatively inexpensive trip to Europe during the summer season, instead of opening up his elaborate and costly warm-weather retreat in the Adirondacks. But so far as his needs and most of his comforts are concerned, he does not suffer. He does not have to cut down on his consumption of meat, his children need not go without milk, nor are he or his dependents in danger of eviction from their home for non-payment of rent.

But it is precisely these hardships, and others of similar nature, that must be endured by the families of many workingmen whenever a serious business depression overtakes society; and this, judging from past experience, means at least once in every decade. In our discussion of unemployment, we gave some attention to the human suffering caused by a shortage or total loss of income during periods of depression. There is no need to multiply the harrowing

[19] In this statement is found the answer to a question that is often asked, Does not the extravagant spending of the rich benefit the poor by providing them with work? The concentration of money *does* lead to a demand for expensive goods, and thus it provides employment. But this money, if more equally distributed, would still lead to a demand for goods—though, as we have suggested above, for goods of a simpler type—and there is no reason to suppose that it would provide any less employment than when spent for luxuries.

details, as related by social workers. That privation is the portion of many in our years of industrial blight is evident from the fact that, in the great post-1929 depression, less than five dollars a week *per family*, provided by a Relief Committee, was the sole income of most of the unemployed of Philadelphia who received aid from this Committee. Certainly, a very large number of the 12 million unemployed Americans fared no better than the jobless citizens of Philadelphia and other great cities. The wealthy and middle classes may have to "retrench" at times, as we have indicated above, but they know nothing at first hand of the "skimping" that falls to the lot of millions of members of the so-called working class.

The hazards of occupational disease and industrial accidents fall very heavily upon the wage-earning group. We noted in Chapter 6 the inadequacy of the accident compensation laws of most of our states. Except so far as hospitalization and medical treatment are provided through social or governmental agencies, the cost involved in securing these vital services either places them beyond the reach of the average worker or, by consuming a part of his income, crowds other essential items out of his meager family budget. The outcome of this situation is that many people who need medical attention fail to get it. In a nation-wide survey conducted in 1938, the American Institute of Public Opinion found that 42 per cent of those interviewed throughout the country said that they had put off going to the doctor, at some time or other, because of the cost. And, of course, the loss of working time that results from accident or illness affects the worker's income in a way quite outside the experience of those whose incomes are derived from property. Interest and dividends are wholly independent of the health of their recipient. The fact that he is well or sick, working or idle, does not affect the regularity or the size of such payments. Wage incomes, on the contrary, depend upon the health of the worker in the sense that usually they are promptly cut off if ill health interferes with his ability to engage in productive work.

The rich get old as surely as the poor, though perhaps not so rapidly, if we think in terms of physical deterioration, since they are able to get the best medical and surgical attention that money can buy. In the preservation of health, more fully than in most matters, it is true that a stitch in time saves nine. The great age of some of our millionaires is at least partly attributable to their ability to engage the services of personal physicians, whose duty it is to keep

their employers in health, and to the fact that any aid to health—such as residence in Florida in winter and in Maine in summer—is well within their reach. But whether physical decline comes soon or late, economic old age, in the form of loss of income, overtakes large numbers of our citizens and, in effect, makes beggars of them. The prospect of old age seldom holds for the rich the same fear of dependency that it holds for the poor. We have already seen that of all persons in this country who attain the age of sixty-five, two-thirds are dependent upon public or private charity, either wholly or in part. Now, no one would contend that the groups whose incomes appear in the upper income brackets—that is, the well-to-do and the wealthy—furnish their per capita share of these aged paupers. The specter of old age dependency is reserved almost exclusively for the contemplation of the propertyless masses—those who have no personal stake in the great accumulation of national wealth of which even they have been taught by press and public school to be proud.

We are concerned here not with the *manner* in which economic insecurity causes the annual incomes of millions of our people to be lower than they would otherwise be, but with the fact that, because their customary wages are low, a loss in income is a much more serious matter to them than to those whose normal incomes are high. Coming events cast their shadows before, and the psychological effects of the temporary or permanent loss of economic competency long precede the fact, because of the worker's ever-present fear of that loss. Its physical effects are paraded before his very eyes, as he sees his children stunted, both physically and mentally, by his inability to secure the steady income needed to provide for their proper development.

Furthermore, whatever uncertainties the incomes from property may be subject to, it is evident that variations in these incomes do not lead to such grave effects upon the lives of their recipients as are produced by fluctuations in wage incomes upon the daily lives of the large percentage of our population that find it impossible to accumulate property. Wage incomes do not permit of expansion to meet the needs of emergencies. As one writer has pointed out, "a wage or salary can rarely be capitalized in times of special need, such as illness (except by means of insurance payments), while income from property, unless the capital is 'tied up,' can within limits

be increased at will, by selling or mortgaging part of the principal."[20]

Economic Inequality and Educational Opportunity. According to figures compiled by government officials, approximately 23 per cent of the total population of the United States was enrolled in schools and colleges in the year 1936. Table 24 shows the distribu-

TABLE 24. ENROLLMENT IN SCHOOLS AND COLLEGES IN THE UNITED STATES, 1936 [a]

	Number	Per Cent
Elementary and kindergarten	22,706,805	74.8
Secondary schools	6,424,968	21.2
Colleges and normal schools	1,208,227	4.0
Total	30,340,000	100.0

[a] Source: *Statistical Abstract of the United States, 1939.*

tion among the several classes of educational institutions. The enrollment was heavy in the elementary schools, but decreased greatly in the secondary schools, and still further in colleges and normal schools. If all children were to continue their education through high school and college, we should expect the number of secondary and college students together to approximate the enrollment in elementary schools, since the elementary work covers as long a period of time as the high-school and college work combined. However, we find that there were only one-third as many students in secondary schools and colleges as in elementary schools in 1936. A rough and admittedly inexact calculation indicates that of every group of 100 elementary students, about 55 reached high school while only about 10 went on to college or other institutions of advanced training. Comparable figures were 40 in high school and 10 in college in 1930, and 67 in high school and 14 in college in 1940.

We have no intention of suggesting that all students who fail to get to high school or college are the victims of economic inequality. As everyone knows, there are many boys and girls who are so lacking in ability that they simply cannot "make the grade," while others

[20] Josiah Wedgwood, *The Economics of Inheritance*, London, George Routledge & Sons, Ltd., 1929, p. 10.

detest mental exertion so heartily that they insist on ending their formal education at the earliest possible moment. The fact remains, however, that education—even "free" education—is costly, and large numbers of boys and girls with good minds and abundant ambition are forced by economic necessity to get along without it. The existence of child labor on a large scale [21] in some sections of the country means that even an elementary education is beyond the reach of a considerable portion of the population. Laws providing for compulsory school attendance, but specifically exempting children whose parents cannot supply them with proper clothing—as do the laws in some of our states—are sufficient evidence that education may be "free" and at the same time so expensive that members of our low-income groups are unable to take advantage of it. We have here, in all probability, at least a partial explanation of the fact that in 1930 there were 4,283,753 illiterates in the United States.[22] This number included 4.3 per cent of the total population over ten years of age.

Despite the growth of tax-supported elementary schools and high schools and the great development of state universities, it still remains relatively true that learning and the paraphernalia of culture are readily available to the children of the well-to-do, but difficult of attainment by the poor. When the son of a coal miner quits school as early as the law allows, or as soon as he can get his working papers, we are not surprised. If the son of a rich man fails to get his bachelor's degree, it is a matter for inquisitive comment. The "health and decency budget" of the American worker includes no allowance for "higher education," but the son of the wealthy business or professional man goes to college as a matter of course, and spends in a college year a sum greatly in excess of the average *total family income* of the unskilled or semi-skilled workers of this country.

The oft-repeated statement that anyone who has ability and really wants a college training can get it, is simply not true. It is a bit of pleasant palaver, comparable to the saying that every boy has a chance to be President. The fact is that an ambitious young man may be prevented from going to college or professional school by

[21] In 1940, there were 1,278,812 children, fourteen to seventeen years of age, listed among the "gainful workers" of the United States. This figure included 5.2 per cent of all persons in the country who were fourteen or fifteen years of age, and 21.0 per cent of all persons sixteen or seventeen years old.

[22] *Statistical Abstract of the United States, 1939*, p. 41.

the absence of a high-school training, which was rendered impossible by the necessity of contributing to the family budget in early youth; he may lack the unusual physical stamina that is needed to pursue college studies and earn a living at the same time; or he may find it necessary to help support his family but impossible while paying his college expenses and carrying his college work. Obstacles such as these may easily be insurmountable even for an exceptionally able young man. They are difficulties such as the well-to-do and the wealthy seldom have to face. As a consequence of inequalities in income, the enrollment in our colleges and universities is based very largely on financial status. To a lesser degree, this is true of secondary schools also.

The absence of equal opportunity for education means that the members of families having small incomes are greatly restricted in their choice of occupations. Having made a study of the movement of individuals between classes in England, Professor Morris Ginsberg reached the conclusion that "the social ladder so far lifts only relatively small numbers." The difficulties experienced by working men in rising to higher economic positions have led some Europeans to refer to the United States as the land of unlimited opportunity. However, the data on American incomes presented in this chapter show that, while we are an extremely wealthy nation, we are not so prosperous as individuals. The all-important consideration is not the *possibility* but the *probability* of "getting up in the world." Inequality of income provides both a large number of persons anxious for economic advancement, and an attractive goal toward which to strive, but it brings so great an inequality of educational opportunity as to make advancement for the masses highly improbable. "A right to the pursuit of happiness," as Mr. R. H. Tawney points out, "is not identical with the right to attain it." Until we have a larger degree of equality of income, it is idle to speak of equality of opportunity.

Economic Inequality and Legal Justice. Equality before the law is a matter of supreme importance, and civilized nations have long boasted that they provide a legal "square deal" for all persons, of both high and low degree, coming within their jurisdiction. But for some years there has been growing up, in America at least, the notion that the law before which all are supposed to be equal provides one kind of justice for the rich and another for the poor. This unpleasant suspicion arises from the fact that while all citizens may

be equal before the law, the machinery through which the law operates works most smoothly and satisfactorily for those who are able to pay a good price. We are not suggesting that judges and juries are susceptible to bribery, though this is occasionally the case. Rather, we have in mind the costliness of legal procedure. The services of lawyers, with certain honorable exceptions, are bought and sold in the open market, as material and labor for manufacture are bought and sold. This means, when combined with the practice of assessing court costs, that equality before the law is little more than a legal fiction, since justice dealt out under such circumstances has a price, just as truly as an automobile, a coat, or a loaf of bread has a price.

The almost insuperable obstacle that faces a poor man who challenges a rich individual or corporation in the courts is illustrated by the following example of one expensive phase of legal procedure—the cost of appeals to higher courts:

> Once upon a time there was a brakeman who sued a railroad because of injuries sustained in the course of his work. He was awarded $4000 damages. The company appealed, and two years later the judgment was reversed. The brakeman sued again, and this time was awarded $4900 damages. The company appealed, and again the judgment was reversed.
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> Three years after this the plaintiff sued a third time. In this instance the judgment was for the company; whereupon, five years later, the brakeman himself appealed. Failing, he went to a higher court, and, after another three years had passed, won a reversal and a fourth trial. He won a fifth trial. The company appealed. He won a sixth trial. The company appealed. With a seventh trial the business reached its end, and the plaintiff walked away $4500 richer and eighteen years poorer. Poorer, too, for whatever he had paid out in legal fees.[23]

Moreover, those whose purses are well lined are enabled—through postponements, appeals, and other legal devices—to put off and often to escape the consequences of violations of the law that would quickly land lesser men behind the bars. The oil scandals and other malodorous federal cases that were aired some years ago indicated clearly that it pays to be well heeled when the law is on one's trail. Indeed, it sometimes appears that the chance of evading punishment for misdeeds is directly proportional to the size of one's bankroll. The wholesale rumrunner is more completely immune from successful prosecution than the retailer who peddles by the pint. The

[23] *The New York Times*, February 14, 1940.

banker who steals on a large scale is less likely to draw a long sentence than the clerk who deals in petty theft. For the vast majority of principals in both civil and criminal cases, as we have already intimated, the lower courts become in fact the courts of last appeal, but for those who have abundant financial resources the higher courts open up almost endless possibilities for the delay and even the perversion of justice. "There is one law for the rich and another for the poor," writes Professor Laski, "whenever the preparation of a defence is an item of importance in the case." Something could be done in the way of aiding justice in our criminal courts, if we were to provide *public defenders* of ability as we now provide *public prosecutors,* so that the defendant's case would be adequately presented regardless of his financial status; but on the whole we need not look for genuine equality before the law until we have achieved at least a reasonable degree of economic equality.

Economic Inequality and the Control of Government. What has been said about economic inequality meaning inequality in standards of living, economic security, educational opportunity, and access to the courts may seem to some readers to be more or less obvious. In the field of politics, however, we see an aspect of inequality which is much less generally recognized, but which must not on that account be considered less important than the inequalities we have already noted.

The enthronement of the principles and forms of political democracy, in the late eighteenth and early nineteenth centuries, did not mean that all men were to have an equal voice in government, despite the fanciful dictum, "All men are created free and equal." It meant, rather, that political power was to rest with those who already held economic power. In a capitalistic system of society, economic power is derived chiefly from the ownership of property. It is primarily the distribution of property, therefore, which determines the distribution of political power.

"Government is a form of social organization which has developed because, in the long run, it has afforded the means of supplying men with certain services more efficiently and more economically than these could have been supplied by each for himself." [24] But precisely which services are to be supplied socially is a question that is not decided merely by setting up a definition of this kind. Whether

[24] H. L. Lutz, *Public Finance,* New York, D. Appleton & Company, Inc., 1936, p. 3.

the provision of electric current, compensation for industrial accidents, or tariff protection against competing commodities should be undertaken by governmental agencies are matters which must ultimately be determined by political means. With strict equality of political power, a laborer would have quite as much influence as his employer in deciding such questions. Henry Ford and his lowliest mechanic, for example, would have an equal voice in determining how high the tax on super-incomes should be. But no intelligent person believes for a moment that this is the situation today.

It is not without significance that when ex-Ambassador James W. Gerard set out to name the actual rulers of the United States some years ago, he drew up a list of sixty-four wealthy industrialists and financiers, including a sprinkling of prominent newspaper publishers. In any modern political state, numerous and diverse demands are continually being made upon the government by the citizens. Not all of these demands can be satisfied. Consequently, there must be adopted some process of selection through which the government may choose from among these multitudinous demands those which shall be met, and announce, for instance, "We shall provide pensions for the veterans of foreign wars, but not for the veterans of industry." This process of selection is one of necessity. If an administration is to survive, it must satisfy the demands of that portion of the electorate that is most powerful—that is, of those citizens who, if their wishes are not complied with, will bring about a change in administration. The extent to which individuals can gain recognition of their desires depends, therefore, upon their ability to enforce their demands. The ability to enforce political demands is a function of economic power which, except where labor has mobilized its strength for collective political action, rests primarily upon the ownership of property. To expect any substantial degree of equality of political influence in the presence of great inequality of wealth and income is to assume that men possessed of tremendous economic power will refrain from exercising that power through political channels. That they do not refrain is sufficiently clear from past experience. Rather, by the expenditure of large sums, they influence nominations and elections, and demand that our legislators pass measures that will strengthen them—the propertied classes—in their control of the political machinery of the country. "These men," said Mr. Gerard, in submitting his list of America's "rulers," "are too busy to hold political office, but they determine who shall hold

such office." Here, then, is another form of gross inequality that has grown out of economic inequality, upon which it continues to fatten. And here, again, the remedy, if we are to find one, appears to lie in the achievement of a larger degree of equality in the distribution of income.

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1. "Inequality breeds inequality, and thus perpetuates a condition that keeps some persons from attaining the full development of their abilities." Explain.
2. Argue that equality of opportunity does, or does not, exist in the United States today.
3. Cite figures showing that there is inequality in the distribution of income in this country.
4. What was the *average* income in the United States in 1935–36, as computed by the National Resources Committee?
5. "The larger the income, the smaller is the proportion of the income that comes from wages and salaries, and the larger is the proportion from property." From what source is it possible to get information of this kind?
6. What is the meaning of the term "standard of living"?
7. What items are included in a "minimum health and decency" standard of living? How much does such a standard cost?
8. Through what process of reasoning may we arrive at the conclusion that there is "poverty for many in this land of plenty"?
9. It is believed by many that "conspicuous consumption" arises very largely out of inequalities in income. State the line of argument that appears to lead to this conclusion.
10. Is the purchase of very expensive luxuries by the wealthy beneficial or harmful to the poor? Explain.
11. Cite examples of extravagant expenditure.
12. What can be said for the argument that the conspicuous spending of the rich provides work for those who would otherwise be unemployed?
13. Discuss the consequences of business depressions, as they affect the well-to-do and the wealthy, on the one hand, and the poor, on the other.
14. "Interest and dividends are wholly independent of the health of their recipient, but wages are not." Explain the significance of this statement.
15. "The rich have a better chance than the poor of living to a 'ripe old age.'" Why?
16. Discuss the relationship between economic inequality and educational opportunity.
17. What percentage of the population of the United States is illiterate?
18. Is it not true that anyone who has ability and really wants a college training can get it? Explain.

19. This chapter argues that the poor fare less well than the rich, so far as legal justice is concerned. Defend or refute this contention.
20. Explain the significance of Mr. Gerard's statement about "the actual rulers of the United States."

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19. Economic Inequality: Causes and Cures

Keeping in mind the consequences of economic inequality, as outlined in the preceding chapter, we may now inquire briefly into its causes and then suggest some measures the adoption of which would certainly bring about a larger degree of equality of opportunity than now exists, and might even make life bearable for those who, because of their limited endowments, are unable to "make good" when thrown wholly upon their own resources.

The Causes of Economic Inequality

Differences in Natural Endowments and in Luck. If we could trace economic inequality to its beginnings, we should doubtless find that it has started, in all instances, either from inequalities in individual abilities or from inequalities in "luck as regards circumstances which it is beyond the power of the individual either to forecast or control." [1] The existence of differences in natural endowments is beyond dispute. Even within the limits of a single family are found variations of such extent that, despite equality of environmental opportunity, one child reaches great heights while another barely escapes mediocrity. No one who has looked into the matter at all carefully is likely to make the mistake of contending that all men are created equal, in the sense of being provided by nature with identical mental and physical capacities.

On the question of luck, there is perhaps more room for argument. Some persons subscribe to the copybook maxim of James A. Garfield that there is no such thing as luck, while others are more inclined to agree with the late Julius Rosenwald, the multimillionaire head of Sears, Roebuck and Company, who once said, "I believe that suc-

[1] Josiah Wedgwood, *The Economics of Inheritance*, London, George Routledge & Sons, Ltd., 1929, p. 57.

cess is 95 per cent luck and 5 per cent ability."[2] Probably the truth lies somewhere between these two extremes. There are certainly some great economic successes that have had in them a large element of luck, chance, or good fortune—call it what you will—while examples are not lacking of achievements that seem to rest chiefly, if not wholly, upon the possession of unique abilities.

Differences in Environment. But however inequalities may have come about in the first place, there can be no doubt that they have been perpetuated, in many instances, through differences in environment and through inheritance. Americans in particular are prone to advance the argument that persons of ability may be trusted to rise above their environment, no matter how hopelessly situated they may appear to be. The cheerful philosophy that a good man cannot be kept down has been properly and seriously questioned by Professor Hobson, who says:

> The notion that genius, like murder, will "out" is a false sentimentalism. Some men of genius do, indeed, make their way in spite of adverse circumstances, forcing themselves out of the obscurity of their surroundings; they "break their birth's invidious bar, and breast the blows of circumstance, and grasp the skirts of happy chance." That is to say, some sorts of genius are united with qualities of audacity, persistence, and luck, which enable them to win "through." But how many men of genius do not possess these faculties and therefore do not emerge, it is from the nature of the case impossible to learn. But it is probable that much genius, talent, and ability, capable of yielding fine social service, is lost. Indeed, it is probable that many of the finest human variations, involving unusual delicacy of feeling and perhaps of physique, will by natural necessity be incapacitated for making their way and forcing recognition amid uncongenial surroundings.
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> It is likely that far more human genius is lost than is saved, even in the more civilized nations of today. For what are the conditions of the successful utilization of genius, and for what proportion of the population are they securely attained? Leisure is a first condition for all free and fruitful play of the mind. . . . Education is the next condition. . . . Until all the new minds brought into the world are placed in such free contact with every fertilizing current of thought and feeling, and enjoy free, full opportunities of knowing the best that has been thought and said in all departments of human knowledge, we cannot tell how much creative faculty perishes for lack of necessary nutriment.[3]

[2] *The New York Times*, January 7, 1932.

[3] J. A. Hobson, *Work and Wealth*, New York, The Macmillan Company, 1926, pp. 51, 52.

Inequalities, then, are passed on from generation to generation because of the environmental differences that result from inequalities. As Professor Pigou puts it: "The environment of one generation *can* produce a lasting effect, because it can affect the environment of future generations. Environments, in short, as well as people, have children." [4] The environment of the well-to-do is conducive to the development of native abilities; the environment of poverty is not. Thus we have a vicious circle, in which economic inequalities lead to inequalities of opportunity, and these in turn give rise to still further inequalities in economic status. "Wealth in modern societies is distributed according to opportunity," writes Mr. Tawney. "And while opportunity depends partly upon talent and energy, it depends still more upon birth, social position, access to education and inherited wealth; in a word, upon property. For talent and energy can create opportunity. But property need only wait for it." [5]

Obviously, the prospects of two boys of equal natural endowments—one the son of a pick-and-shovel man, the other born of wealthy parents—are widely different. The former, as Mr. Tawney suggests, may create opportunity through his heritage of talent and energy, but the latter has opportunity almost thrust upon him. From childhood to manhood, his health is looked after; his schools and college are chosen with care, and tutors are provided if they appear to be necessary; the proper social contacts are developed; and, finally, if he is to take up business or a profession, his father, or other relative, or perhaps a friend of the family, is ready with a suitable opening.

The Influence of Inheritance. But inequalities are passed on, also, through the institution of inheritance. Indeed, inheritance is believed by most economists to be the chief agent for the perpetuation of economic inequalities. The figures given in Table 23 show clearly that the ownership of property accounts for much of the income received today by the well-to-do and the rich. Through inheritance, this property is handed down from father to son, and the inequalities of today become the inequalities of tomorrow. Professor Taussig, in dealing with the effect of inheritance upon inequality,

[4] A. C. Pigou, *The Economics of Welfare*, London, Macmillan & Company, Ltd., 3rd ed., 1929, p. 115.

[5] R. H. Tawney, *The Acquisitive Society*, New York, Harcourt, Brace & Company, Inc., 1921, pp. 33, 34.

says: "Its influence is enormous. It is this which explains the perpetuation of the incomes derived from capital, land, income-yielding property of all sorts, and so explains the great continuing gulf between the haves and the have-nots." [6]

Not only are inequalities continued through inheritance, but in many instances they are vastly increased, since great fortunes have the habit of multiplying. The Astor fortune, started by John Jacob Astor more than a century ago, is a case in point. The 20 millions left by him in 1848, plus a half-million left by Henry Astor, had by 1905 grown to 275 millions. It is possible, of course, that those through whose hands this fortune passed added to it not only by saving a part of the interest, dividends, and rents that this great accumulation of property brought them, but by exercising their personal abilities as well. But whether true or not, this point does not concern us here. What is important for our purposes is to note that there was no need for the descendants of John Jacob Astor to exert themselves unless they wished to do so. The property at their disposal assured them an income so large that whatever they desired in the way of "the good life" was theirs for the asking, provided only it was something that could be had for money.

Inherited wealth has a slighter influence upon economic inequality in newly settled countries than in those which have been long exploited, because of the greater opportunity to acquire an income through taking up cheap land, or getting in on the "ground floor" of an industry and "growing up" with it. But this is a stage which passes fairly quickly. On this point Professor Cannan has observed: "As the United States ceases to be a 'new' country, more and more property will be inherited in proportion to that which is acquired in the lifetime of a generation, and there will consequently be more scope for inequality of inheritance. . . . America may be free from inequalities arising from grants of land made by William the Conqueror, but it is just as easy to be the lucky inheritor of a farm which becomes part of the site of a great city there as in England. The Astor inheritance in America has the same source as the Grosvenor inheritance in England, and the Vanderbilt and Morgan millions are no more likely to 'disintegrate' than those of the Rothschilds." [7]

[6] F. W. Taussig, *Principles of Economics*, New York, The Macmillan Company, 4th ed., 1939, vol. ii, p. 298.

[7] Edwin Cannan, *Wealth*, London, P. S. King & Son, Ltd., 1924, pp. 183, 184.

As was suggested in the last sentence of the preceding paragraph, the day has passed when the old adage of "three generations from shirt-sleeves to shirt-sleeves" had some significance. Some of the fortunes of today are so huge that there is no danger of their being dissipated, particularly in view of the recent development and wide use of trust funds. Though invested, in the interests of security, at a very low rate of return, they still provide incomes so large that they cannot be spent without genuine effort on the part of the recipients. Hence it is that the concentration of wealth proceeds apace, and inequalities become progressively greater with the passage of time. It seems fair, therefore, to say that the institution of inheritance is the chief instrument in perpetuating and increasing inequalities. Consequently, any serious attempt to solve the problem of economic inequality must include an attack upon this ancient institution which seems to have largely outlived its usefulness.

Proposed Methods of Distribution

The obvious and glaring inequalities in the distribution of income have led certain socially-minded persons to question whether the basis on which income is distributed is fair and just. Indeed, some of the doubters have gone so far as to propose substitutes for the principle of distribution—reward on the basis of contributions to the economic process—which, as we have seen, seems in general to explain the division of the national income among the owners of the agents of production. We shall examine briefly several of the proposals that have been made.

Equality of Income. To some people it seems eminently fair that the total income of the country should be divided equally among the adult members of society. Just as we now grant one vote to every citizen of the United States, so would those who advance this theory of distribution give to every citizen an equal share of the total national income.

This arrangement would have the merit of simplicity, and, if we assume that its adoption would not reduce the national income, it would unquestionably do much to improve the economic status of members of the low-income groups, though of course at the expense of the middle classes and the very wealthy. But there are many who hold that distribution on the basis of strict equality would almost certainly mean a much smaller income to divide; for some persons who now labor long, hard, and skillfully, for the sake of personal

gain, would be unlikely to exert themselves so strenuously for an individual reward which in no case could be greater than the pay of a lazy, careless, or incompetent worker. As we shall see a little later, in our discussion of economic incentive, this argument is not necessarily conclusive, but it is one which cannot be ignored.

A second objection is that some posts in the economic world today seem to require higher salaries than a bare equality in distribution would provide, if the duties of these positions are to be discharged efficiently. An important executive, whose work involves mental concentration, may need more ample quarters at home as well as in the plant, better means of transportation, and more expensive food and clothing, than the machine-tender who is employed in the same establishment. To some extent these "extras" might conceivably be granted him as a *perquisite of office* and not a *personal wage;* but it is entirely possible that some of an executive's "needs" that must be met, if he is to be of maximum usefulness in production, are so largely personal in nature and so highly subject to sudden change, that they could be cared for only by placing at his disposal a very considerable fund to be used as he might see fit. And such a fund, of course, would come dangerously close to being a personal wage.

There is the further fact that strict equality in the distribution of income would run counter to the very general feeling in present-day society, that there should be some relationship between a man's contribution to the national "goods heap" and the amount of goods he is allowed to take from that heap. The familiar saying that a worker should be paid "what he is worth," though it may not stand up well under close inspection, yet suggests the prevalence of the notion that some contribute much to production and others but little, and that each should be paid *in proportion to his contribution.* Public opinion, even if it happens to be mistaken, is a factor that must be reckoned with.

Finally, differences in individual incomes of a given type provide a convenient means of apportioning the agents of production throughout our economic system in such a way as to economize most in the use of those agents which are particularly scarce. We have seen that those agents which are very limited in quantity, and at the same time are much in demand, command high prices. A high price is, of course, a very effective warning that the productive agents to which it is attached—say, a given grade of labor—should be used sparingly, and only in those places where a more

abundant grade of the agent would not serve. Moreover, a high price for labor, or other agent of production, tends to bring about an increase in the quantity of that factor, and thus to overcome its scarcity. In the absence of differences in wages, some other device would have to be set up to insure the most productive use of labor; and this remark is applicable, also, to the apportionment of land and capital among their several possible uses.

Income According to Need. Probably the most nearly ideal principle of distribution that has ever been proposed is the payment of income on the basis of need. Few of its critics have ventured to question the desirability of giving to every member of society an income which would enable him to take care of his needs; but, on the other hand, many have risen up to challenge the feasibility of the plan.

It is said, in the first place, that needs are subjective, and that it is impossible to determine—for every man, woman, and child in the country—just what his or her needs are. Wants might be ascertained readily enough through the simple process of personal inquiry, but probably few persons would hold that a requisition thus drawn up would represent genuine needs and nothing more. However, Professor Hobson [8] and others would insist that, though needs may not be ascertained with absolute accuracy, it is certainly possible for experts in diet, housing, and other fields to determine, within fairly narrow limits, what might be termed the legitimate needs of individual members of society—making allowances, of course, for environmental, occupational, and possibly certain other differences as between individuals.

The payment of income according to need presupposes, of course, that everyone would be glad to pitch in and do his share of society's work. Indeed, the slogan in which this principle of distribution is commonly expressed—"from each according to his ability, to each according to his need"—implies that all members of society may be counted upon to contribute generously of their productive power. But it is by no means certain that the principle would work out this way in actual practice. For if all were assured incomes according to their needs, there is at least a possibility that some would not concern themselves greatly about their obligations as producers. Hence, in addition to the difficulty of ascertaining needs, there

[8] Cf. J. A. Hobson, *Work and Wealth,* London, George Allen & Unwin, Ltd., rev. ed., 1933, chap. 11.

would be the problem of inducing people to work industriously. Unless this problem could be solved, the national income might not be sufficiently large to meet the needs of society.

Income According to Effort Expended. To some persons it appears grossly unjust that people who labor long and hard sometimes receive very small pay, while others with short hours and light tasks draw handsome incomes. Would it not be much fairer, they ask, to reward workers on the basis of the effort they expend, giving large incomes to those who exert themselves greatly in production, and small ones to those who work less diligently?

The answer to this query seems to be that society is not, on the whole, interested in having its members work particularly hard, unless by so doing they turn out goods that society wants. Our present method of distribution rewards workers who make goods that are wanted, and pays premiums to those who produce these goods in unusually large quantities. Since what society wants is *goods*, not *toil*, it pays for the former rather than the latter.

This arrangement tends to direct workers into those occupations for which they are best fitted, since it is here that they are best paid. But if incomes were paid on the basis of energy expended, we might easily have an appallingly large number of misfits in the world of production—those who labored exceedingly hard and were therefore well paid, but who nevertheless turned out—because they were in unsuitable occupations—either an inferior product, or a quantity of product that was excessively small in view of the incomes they received. To adopt this principle of distribution would be equivalent, therefore, to encouraging waste in production. It should be added that it would be exceedingly difficult, if not impossible, to measure accurately the amount of energy expended by every worker in society.

Income According to Social Usefulness. Yet another proposal is that income should be based upon the *social* usefulness of the service that is rendered. Under our present system of distribution, it sometimes happens that larger incomes may be had by catering to the whims of the wealthy than by taking care of the genuine needs of the masses. For example, it may be more profitable, from the point of view of personal income, to build pleasure yachts for millionaires than to put up dwellings for poorly paid workingmen. But the dwellings would probably far outweigh the yachts, if judged on the basis of social usefulness. Should we not, then, encourage the

production of "first things first," by rewarding the producers of necessities more generously than the producers of luxuries?

Possibly so, but the difficulties of administering the principle would seem to be well-nigh insuperable. It would involve not only distinguishing between luxuries and necessities—a very considerable undertaking, since what is a luxury for one person might be a necessity for another—but, in addition, drawing up a list of all economic services that are rendered in a modern civilization, rating them in the order of their social significance, and then deciding upon income differentials which would represent accurately their relative importance to society. This is a task of such dimensions that it is almost inconceivable that it could be performed satisfactorily.

Income According to Productivity. We must call a halt on our survey of principles of distribution which might possibly be substituted for the one that obtains in most economic societies today. And, though we have not been able to do full justice to the substitute plans that we have outlined, we feel warranted in suggesting that, all in all, payment on the basis of productivity seems to us to be the best arrangement that has yet been proposed for distributing income—if we assume the existence of an economic order in which competition, self-interest, free enterprise, and private property continue to play important rôles.

We have no desire to suggest that this is an ideal principle of distribution. Indeed, we have gone to some trouble to point out certain of its defects. But, in spite of its imperfections, payment according to individual productivity has advantages which we cannot afford to overlook or underestimate. It helps to stimulate workers to do their best, and thus it tends toward the maximization of national income. And it is, moreover, a principle which appeals to most people as fair—for who will contend seriously that a man can rightly claim, as a matter of economic justice, more than he produces, or should be required to accept less? Of course, those who under this system cannot support themselves must be supported by the state—but in the name of common humanity, and not economic justice; and individual incomes, based upon individual productivity, must be taxed so that society may be able to meet this and other legitimate expenses of government.

We are far, then, from proposing an absolute equality of income among the members of our economic order. We believe that the

government should undertake to eliminate all anti-social ways of getting income (such, for example, as the exercise of monopoly control, the adulteration of goods, misrepresentation through advertising, and so on), and then encourage every member of society to try to outdo his fellows in *rendering service*—which, as Professor Carver points out, would then be the only means left through which one could hope to get an income.[9] But, as we said at the beginning of Chapter 18, the problem of economic inequality will not be solved until there is equality of opportunity for all members of society, so far as this can be accomplished through the removal of artificial obstacles to the full development and utilization of personal capacities.

The Cures for Economic Inequality

The Need for Equality of Opportunity. From what has been said thus far, it will be seen that we do not hold that the abilities of individual members of society are equal, nor do we believe that it is possible or desirable to attain equality of this kind. Furthermore, we do not contend that incomes should be strictly equal, though we believe the gross economic inequalities that exist today are socially undesirable and must be done away with. That is to say, they must be done away with if we are to have the *equality of opportunity* of which we hear so much and see so little. For equality of opportunity, as Mr. Tawney has shown, "obtains in so far as, and only in so far as, each member of a community, whatever his birth, or occupation, or social position, possesses in fact, and not merely in form, equal chances of using to the full his natural endowments of physique, of character, and of intelligence."[10] The late Stephen Leacock had the same idea in mind when he insisted "that every child of the nation has the right to be clothed and fed and trained irrespective of its parents' lot." "No society is properly organized," he continued, "until every child that is born into it shall have an opportunity in life. Success in life and capacity to live we cannot give. But opportunity we can. We can at least see that the gifts that are laid in the child's cradle by nature are not obliterated

[9] T. N. Carver, *Essays in Social Justice*, Cambridge, Harvard University Press, 1915, chap. 6.

[10] R. H. Tawney, *Equality*, New York, Harcourt, Brace & Company, Inc., 1931, p. 125.

by the cruel fortune of the accident of birth; that its brain and body are not stunted by lack of food and air and by the heavy burden of premature toil. . . . If, with all our vast apparatus of machinery and power, we cannot so arrange society that each child has an opportunity in life, it would be better to break the machinery to pieces and return to the woods from which we came." [11]

Limitations on Inheritance. A little thought suggests that equality of opportunity cannot be achieved so long as huge accumulations of wealth are passed on from generation to generation, in the form of bequests from certain individuals to others. Hence, the first requirement of equality of opportunity would seem to be a thoroughgoing federal estate tax, to prevent the inheritance of large fortunes by individuals and insure their use in the interests of all. If this tax is to do its full share in reducing inequalities, it must take a large proportion of great estates, leaving only a moderate provision for direct dependents instead of the enormous estates that have sometimes placed the children of the wealthy hopelessly in advance of those whose parents have had no property to bestow.

There is much to be said for shuffling the cards between deals, and for having all runners in a race start from the same point. It is equally important that contestants in the race of life should get an even start, so far as the elimination of artificial obstacles is concerned. If inheritance of income-producing property were abolished, we should at last have a chance to judge fairly the qualities of the racers—a chance which is non-existent today under a system that often penalizes the weak and favors the strong. It is scarcely necessary to add that an estate tax, if it was not to be evaded, would have to be accompanied by a gift tax which would prevent the transfer of property in anticipation of death, or would at least tax such transfers at a high rate.

So far as the recipient is concerned, inheritance is obviously "unearned" income; and this fact may account in large part for the willingness of legislatures, both state and federal, to impose upon such income the fairly stiff tax rates that were noted in our discussion of taxation in Chapter 10. If our lawgivers should impose even higher inheritance and estate taxes, they would by so doing provide a larger degree of equality of opportunity than now prevails, by still further

[11] Stephen Leacock, *The Unsolved Riddle of Social Justice,* New York, John Lane Company, 1920, pp 138–140.

weakening the institution of inheritance, the functioning of which is a major cause of economic inequality.

Permanently High Income Taxes. In addition to preventing the inequalities of one generation from being passed on to the next, something should be done to reduce inequalities even in the short run. It seems to us entirely fitting and proper that the wealthy—even those who have gained their wealth through their own efforts and not by inheritance—should be asked to pay a very large part of the running expenses of society. We propose, in this connection, a system of federal income taxes with *permanently* high rates in the high-income brackets.

Just how high these rates should be, we are not prepared to say. This is a matter to be determined by experiment. But our use of high personal income taxes in wartime indicates that our *peacetime* use of income taxation has by no means exhausted our possibilities of securing revenue through this agency. Surtaxes in the United States reach a maximum of 88 per cent on portions of individual incomes that exceed $200,000—but these are, of course, relatively few. Experience in England and other countries seems to indicate that we might well make permanent increases in the rates that apply to incomes in certain brackets, somewhat along the lines of the supposedly *temporary* increases that were adopted to aid in financing our war needs. Such rates, to be "fair"—that is, in accord with the principle of ability to pay [12]—would have to be steeply graduated, taking only a small percentage of low incomes but a large percentage of those running into the hundreds of thousands or millions, though not so large as to deter persons of unusual ability from engaging enthusiastically in productive enterprises. Moreover, they should be so arranged as to lay a particularly heavy toll upon "unearned" incomes—those derived from the ownership of property—while dealing more gently with wages and salaries, since the latter represent a payment for personal services. To prevent evasion of the income tax, there would be need, of course, to eliminate all tax-exempt securities.

The Question of Incentives. It must not be supposed that a permanent tax program of this kind could be put into effect without meeting considerable opposition. Once it was publicly proposed, prophets would rise up and proclaim that a very high income tax would eventually destroy incentive, while a very high estate tax

[12] See chap. 10. The relative merits of various kinds of taxes are discussed in that chapter.

would both discourage production and lead to wasteful spending. But these are matters about which we know little or nothing from actual experience, so that these prophets, being on uncertain ground, would do well to tread softly. In the past, it is true, we have depended chiefly upon the lure of material gain to induce men to do their utmost in the field of production. But it is entirely possible that, in our worship of material things, we have overlooked other incentives that would prove equally potent, if only we brought them into play.

Indeed, there are many callings—such as the military and diplomatic service, and the so-called professions—in which some nonmaterial incentive, such as the desire for authority or prestige, an interest in the work, or the feeling that this task or that is particularly worth while, appears to be a force sufficient to impel men to pursue their occupations with earnestness and enthusiasm. It seems inevitable that, in a society which to a large extent had eliminated economic inequalities, the economic motive would lose much of its power, giving way to other motives that might prove equally productive of economic goods though less productive of human misery.[13]

But this is frankly a field of speculation, with one man's guess about as good as another's. It may be true that an estate tax such as we have proposed would lessen men's desires to work and thus reduce their productivity, or cause them to spend their accumulations before making their final exit. On the other hand, it is equally possible that our captains of industry and merchant princes are more intent upon establishing reputations as leaders in their respective fields than upon establishing fortunes to be handed down to their descendants. The effect of high income taxes upon production is likewise debatable. Some persons believe that such taxes lessen incentive, while others are equally certain that they increase it. The latter argue that if a business man has set \$20,000 as the amount needed to buy a satisfactory standard of living, the imposition of a 50 per cent income tax might spur him on to greater deeds, since he would then need a gross income of \$40,000 in order to have the use of a net income of \$20,000, the amount formerly available for spending.

[13] Readers who are interested in the question of industrial motives should consult J. A. Hobson, *Incentives in the New Industrial Order,* New York, Thomas Seltzer, 1925; and Paul H. Douglas, "The Reality of Non-Commercial Incentives in Economic Life," in Rex G. Tugwell, Editor, *The Trend of Economics,* New York, Alfred A. Knopf, Inc., 1924.

But even if the prophecies of reduced production should be fulfilled, society instead of losing might still be the gainer. For the goal of production is the satisfaction of human wants, and a small volume of economic goods, well distributed, might easily give more satisfaction than a larger volume concentrated in the hands of the few. All in all, then, there is no conclusive evidence that the abolition of inheritance and the heavier taxation of incomes would reduce society's output of commodities and services, or that this reduction, if it should come to pass, would necessarily mean a loss in social welfare.

The Extension of Social Services. The abolition of most inheritance and a system of permanently high taxes on large incomes would do much to reduce economic inequality, and at the same time would produce an enormous amount of revenue. We believe that estate and income taxation should be made to promote equality not only by relieving the rich of their surpluses, but by bestowing upon the poor a substantial portion of the revenue collected in this way. It would doubtless be a mistake to make the distribution on a per capita basis, and in the form of cash. Hence, we propose that it be done in a way that is both simple and sane—through the extension of social services.

We have already advocated[14] the adoption of various forms of social insurance, and the provision of free medical and hospital service for all who need it. Here, surely, is plenty of scope for spending advantageously a considerable part of the revenue of which we are speaking. With the hazards of unemployment, accident, sickness, and old age taken care of, one of the most serious consequences of economic inequality—the worry and hardship of economic insecurity—would be virtually eliminated. Another—the lack of educational opportunity—should be removed through such an expansion of our facilities as would give every boy and girl, man and woman, as much training as he or she is able to absorb. This educational program, of course, would involve not only free tuition in the elementary and secondary schools and higher institutions, but also such allowances for living expenses as would make it unnecessary for the members of working-class families to quit school from lack of funds. Our "free" education must be genuinely free, and not a sham! We have already noted the desirability of having public defenders as well as public prosecutors in our system of legal justice. We now go further, and advocate the development of a free

[14] In chaps. 5 and 6.

legal advising service, provided by the state, from which any person in legal difficulties would be able to secure expert assistance in the conduct of his case; and this assistance must include appeals to the higher courts without cost. Otherwise, there can be no justice worthy of the name.

Conclusion. It will be recalled that we began our discussion of economic inequality with a plea for a readjustment of social conditions that would insure "equality of opportunity for all members of society, so far as this can be accomplished through the removal of artificial barriers to the full development and utilization of personal capacities." We have indicated measures through which we might hope to secure a fair degree of equality in the way of economic security, educational opportunity, and legal justice. With an increase in the number and importance of the functions performed by the state through the extension of social services, we should expect our citizens to manifest a greater interest in the control of government than they have shown in the past. This increased interest, combined with a reduction in the economic power of our "big business men," should weaken somewhat the hold that these "actual rulers" have upon the affairs of government. We do not suggest that our proposals for taxation and social services would bring about exact equality in standards of living, but they would unquestionably do much to reduce the present glaring inequalities. And we do believe—and we regard this as the most important item of all—that our program would establish a substantial degree of equality of opportunity, so that such inequalities as continued would be the result of differences in native endowments and not differences in environmental conditions.[15]

[15] The adoption of this program would not, of course, make up for such serious personal deficiencies as physical invalidism or feeble-mindedness. Hence, to repeat a statement made in chap. 6, "it is probable that there will always be some members of society who, because of physical or mental defects, cannot be expected to support themselves. Unfortunates of these kinds will have to be cared for at the public expense, unless they have friends or relatives who are able to look after them adequately." We believe that such persons should be provided with a standard of living that will enable them to live in health and decency, but that they should be prevented from propagating their kind. It is often suggested that, if their defects are of a transmissible type, these public charges should be required (in return for their maintenance) to submit to segregation or sterilization, since society cannot afford to have an increase in the numbers of those who, even under conditions of approximate equality of opportunity, are so lacking in ability as to be unable to provide for themselves.

In suggesting means for bringing about an increase in economic equality, we have limited ourselves to recommendations which we are convinced could be worked out *within the framework of a capitalistic economy,* as described in Chapter 2. Indeed, we hold that the proposals we have outlined, far from weakening the present economic order, would do much to strengthen it. The best possible safeguard of a given type of social system is the feeling, on the part of its members, that it is essentially fair. Properly administered, our program for providing equality of opportunity should appeal strongly to the pronounced individualistic leanings of the average American, and (assuring him of a chance to develop his personal abilities to the utmost, and to sell the fruits of his labor in a competitive market) give him a new stake in a revivified system of free enterprise from which artificial obstructions had been removed.

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1. "All men are created equal." Examine this statement critically.
2. Compare the views of James A. Garfield and Julius Rosenwald on the subject of "luck."
3. "The notion that genius, like murder, will 'out' is a false sentimentalism," says Professor Hobson. Comment.
4. What, according to Professor Hobson, are "the conditions of the successful utilization of genius"?
5. Explain the significance of Professor Pigou's statement, "Environments, in short, as well as people, have children."
6. "Talent and energy can create opportunity. But property need only wait for it," says R. H. Tawney. Precisely what does this mean?
7. Professor Taussig says that inheritance "explains the great continuing gulf between the haves and the have-nots." Discuss.
8. Show, by reference to the Astor fortune, the possibilities of increasing wealth through inheritance.
9. Why should inheritance have a slighter influence upon economic inequality in newly settled countries than in older countries?
10. Comment on the significance of the old saying, "It is only three generations from shirt-sleeves to shirt-sleeves."
11. Discuss equality of income as a principle of distribution, stating its advantages and disadvantages.
12. "From each according to his ability, to each according to his need" is a slogan that has been used by certain collectivists. Some people say it would not "work out." What is your opinion, and why?
13. "Those who work hardest should get the largest incomes." Comment.
14. It is suggested in this chapter that the government should undertake to eliminate all anti-social ways of getting income. Give examples of income-getting that might be regarded as anti-social.

15. What is the meaning of equality of opportunity, as proposed in this chapter, and why should we seek to attain such equality?
16. What part might taxation play in bringing about equality of opportunity?
17. Might we not destroy economic incentive, if we should undertake seriously to provide equality of opportunity for all? Explain.
18. Distinguish between "economic inequality" and "economic insecurity."
19. Examine carefully the implications of the term "free education."
20. Even though perfect equality of opportunity should be attained, there would still be some members of society who were unable, because of personal shortcomings, to earn a satisfactory living for themselves. What should society do about such persons?

REFERENCES FOR FURTHER READING

See list of references at the end of Chapter 18.

PROBLEMS OF GOVERNMENTAL CONTROL

20. *Agriculture*

The wide publicity given the agricultural problem in the two decades before World War II made most Americans aware of its existence, but there were many who did not take this problem seriously. They regarded our farmers as no worse off than other enterprisers, but a good deal noisier about such troubles as they had. It is likely that this attitude resulted from a lack of understanding of the situation. It is difficult to believe that anyone thoroughly familiar with the importance of American agriculture, and the nature of its difficulties, could have failed to see the seriousness of this problem.

The Importance of American Agriculture. Agriculture is important as a source of both food and raw materials used in manufacturing industries. The farm population in 1944 was 25,521,000, or 18.6 per cent of our estimated total population. There were 6,097,000 farms in 1940, and the total value of farm land and buildings amounted to $45,592,000,000 in 1944. The gainfully employed in agriculture in 1944 numbered 10,030,000 persons, or 15.8 per cent of the total for the country. The number of gainfully employed in agriculture was greater than in any other branch of economic activity except manufacturing, in which the total was 15,437,000, or about 54 per cent greater than in agriculture.[1]

Clearly, an industry as extensive as agriculture is of great importance to other industries and to the country as a whole, and not merely to those who devote their energies to it. It is difficult for manufacturing industries or other economic activities to prosper when the farmers' income is greatly reduced, or for the nation as a whole to achieve a high level of economic welfare with American agriculture on the verge of economic ruin. And this was the condition that prevailed in our farming industry in the great depression following 1929.

[1] These data are from the National Industrial Conference Board, *The Economic Almanac for 1945–46,* New York, 1945, pp. 159, 160, 174, and 208.

The Causes of the Farm Problem

The main problem of agriculture, or at least the one which is best known, is the unfavorable price-cost relationship for major farm products, and the unsatisfactory general levels of farm income which have prevailed since World War I. But the farm problem is in reality a group of closely related problems, which include soil erosion, dust and flood control, the migration of farm workers, farm debts, farm credit, tax delinquency, share-cropping, farm tenancy, and many other matters. Our discussion will deal for the most part with the main problem of price-cost relationships.

The Question of Overproduction. The main farm problem was not wholly a product of the post-1929 depression. It had existed in more or less serious form at least since the end of World War I in 1918, and was merely intensified by the depression. If a large number of individuals selected at random were asked to name in a word the cause of the farm problem, it is probable that the majority would blame *overproduction.* Let us see what this term means, as applied to the agricultural problem. It is practically certain that this country has not in recent years had an overproduction of farm products, in the sense of more farm goods than our people would have willingly used if they could have obtained them without payment. And it seems equally likely that our total farm output of recent years could have found purchasers at some price or other.

Whatever overproduction has occurred has been overproduction in the sense that the quantities of farm goods that have been turned out have not been salable at prices which would cover their costs of production, in the economic sense. As a consequence, large surpluses of some kinds of farm products accumulated, and in the matter of real income the farmers steadily lost out, as compared with other types of American producers. Many factors contributed to bring about this unfortunate and inequitable situation.

The War Demand for Farm Products. The tremendous foreign demand for American farm products, during and immediately after World War I, gave a great stimulus to agricultural production in this country. The countries at war had to take many men, and in some cases much land, out of agricultural production, with the result that the output of farm products, especially in Europe, fell off greatly. The countries affected were anxious to buy at high and even exorbitant prices all the farm products that we of the

United States would send them. Hence, the war period was one of rapid increase in the foreign demand for our agricultural produce.

Supply Changes. On the supply side, important changes took place at about the same time. In the first place, the mechanization of agriculture developed rapidly. The tractor came into more general use on the farm during this period, and made possible the development and utilization of larger, more complicated, and more efficient farming implements of other types than had previously been used. Again, methods of cultivation were improved under the guidance of the United States Department of Agriculture. Our farmers learned much about the control of insect pests and other crop parasites, the benefits of seed selection and proper fertilization, and the most improved methods of animal breeding and feeding. Finally, as a result of the favorable price situation, the improved methods of cultivation, and the mechanization of the farms, still other changes in agriculture took place. It now became feasible to bring under cultivation land areas which had been too poor to use under former conditions. Farmers were encouraged to specialize in raising money crops for the market, instead of continuing to engage in diversified farming. The increasing use of mechanical power, both on and off the farm, reduced the amount of land needed to produce feed crops for animals, and the land released in this way was often devoted to producing more of the great staple money crops.

Wartime Production and Income. Under the influence of favorable demand and supply conditions, agricultural production as a whole increased by about 10 per cent between 1915 and 1920,[2] the acreage under cultivation expanded slightly, and exports of agricultural products grew. Net income from agriculture increased from $5,921,000,000 in 1915 to $12,699,000,000 in 1919.[3] This large increase in income would not have meant much to the farmers if the prices of the products they bought had increased as fast as the prices they received for their own products; but this was not the case. If the years 1909 to 1914 are taken as the base period for index numbers of both prices received by and prices paid by farmers, we find that prices received by farmers were 204 in 1918, while

[2] Board of Governors of the Federal Reserve System, *Agricultural Adjustment and Income,* Postwar Economic Studies No. 2, Washington, 1945, p. 2.

[3] National Industrial Conference Board, *The Economic Almanac for 1945–46,* p. 168.

prices paid by them were 173. In 1919, these two index numbers were 215 and 198, respectively.[4] Therefore, the farm income of this country increased both absolutely and in relative purchasing power during the war and early post-war years.

Post-War Conditions. But these favorable conditions for our agriculture did not last long. After the close of World War I, agricultural production picked up in Europe so that within a few years many of the European countries had reached the pre-war level in this respect. As a result, their demand for American farm products declined. Moreover, many of the less highly industrialized parts of the world were able to increase their agricultural production substantially through the use of improved methods and machinery; and they began to compete strenuously for the foreign markets which Americans had been supplying with farm products. Some European countries were not content to have their agricultural production merely reach pre-war levels. Under the influence of programs of extreme nationalism, many attempted to become self-sufficient, or largely so, with respect to important foods and raw materials which they had formerly imported in large quantities. This they did despite the fact that their land areas were often poorly adapted to raising these goods, so that the costs of producing them at home were excessive.

The American policy of discouraging imports, as developed in our high protective tariff laws after the war, hindered our farmers in their efforts to retain export markets. The eventual and inevitable curtailment of the large loans Americans had been granting abroad for the purpose of financing exports increased the difficulty of selling farm products to foreigners. From the domestic point of view it may be true, as is often claimed, that changes in the diet of the American people had a depressing influence on the market for farm products, and the adoption of prohibition may have had a similar effect.

In the face of unfavorable market conditions at home and abroad, agricultural production in the United States increased another 10 per cent during the 1920's. The prices of agricultural products which had dropped 41 per cent from their wartime peaks by 1921 remained low during the 1920's, whereas prices paid by farmers were much better maintained.[5] By 1929, the index of prices received

[4] *Ibid.*, p. 170.

[5] Board of Governors of the Federal Reserve System, *Agricultural Adjustment and Income*, pp. 3, 4.

by farmers stood at 149 on the basis of 1909–14 prices as 100, while the index of prices paid by farmers was at 167.[6] Net income from agriculture, which had reached a peak of $12,699,000,000 in 1919, varied between 7 and 9 billion dollars in the 1920's and was $8,720,000,000 in 1929.[7] Thus agriculture was relatively depressed during a period in which industry was experiencing a boom of unprecedented proportions.

Agriculture in the Great Depression. With the coming of the great depression after 1929, the bottom really fell out of the market for agricultural products, and exports declined drastically. On the other hand, agricultural production was well maintained during the depression and declined only to 117 (1909–14 = 100) in 1932, the worst year of the depression.[8] The net income from agriculture fell from $8,720,000,000 in 1929 to $3,040,000,000 in 1932.[9] The effects of the decline in farm income were the more severe because the prices received by farmers for their products fell faster and further than the prices paid by farmers for the goods they bought. The index of prices received by farmers fell from 149 in 1929 to 90 in 1931 and 68 in 1932, while the index of prices paid by farmers fell only from 167 in 1929 to 142 in 1931 and 124 in 1932.[10] The *ratio* between these index numbers in 1932 was about 55. This means that in that year the farmers, by giving up products worth $1.00 in terms of the base period, could obtain other products worth 55 cents in terms of the same period.

Many of our manufacturing industries, by virtue of their monopolistic or monopoloid situations, were able to keep prices relatively stable during the depression and take their losses in the form of idle plant and equipment rather than by selling their products at low prices. For example, from 1929 to the spring of 1933, the output of farm implements dropped 80 per cent, of motor vehicles 80 per cent, of cement 65 per cent, of iron and steel 83 per cent, and of automobile tires 70 per cent. However, the prices of farm implements in this period declined only 6 per cent, of automobiles 16 per cent, of cement 18 per cent, of iron and steel 20 per cent, and

[6] National Industrial Conference Board, *The Economic Almanac for 1945–46*, p. 170.

[7] *Ibid.*, p. 168.

[8] Board of Governors of the Federal Reserve System, *Agricultural Adjustment and Income*, p. 3.

[9] National Industrial Conference Board, *The Economic Almanac for 1945–46*, p. 168.

[10] *Ibid.*, p. 170.

of automobile tires 33 per cent.[11] If, in the face of a declining national income, some prices do not fall, the effect is to depress other, competitive prices to a greater extent than would otherwise be necessary. The farm industry, being operated by millions of independent enterprisers, was unable to protect itself in this situation, and the fall in farm prices was disastrous.

The Insensitiveness of Farming. Two important questions should be raised at this point. The first of these is, Why did not the farm industry, like the manufacturing industries, recognize the existence of unfavorable demand conditions and reduce output all along the line? And the second question is, Would not the farm problem have solved itself eventually through the operation of natural economic forces, such as the business failure of increasing numbers of farmers and the gradual reduction of the acreage in cultivation and, hence, in the size of crops?

In answer to these questions, it may be said that farming is apparently less sensitive than most industries to changes in demand conditions and the prices of its products. When manufacturers can no longer make ends meet, they fail and their output is withdrawn from the market. Or, in some instances, manufacturing concerns, before reaching the failure stage, decide to cooperate with one another in the reduction of output and maintenance of prices. The farmer seldom fails. Those who have lent him money are usually lenient in allowing him to continue in business, even though he defaults on his obligations. Even when he loses his farm through mortgage foreclosure, he is often permitted to remain on the land and cultivate it. Moreover, it is practically impossible for the many independent growers of a crop to cooperate with one another voluntarily to restrict output and maintain prices as manufacturers are given to doing.

So long as the farmer can stay on the land, he is likely to keep on producing to the utmost of his ability, for his total costs are made up largely of fixed costs. Payments for interest, rent, and taxes cannot be reduced readily, and the farmer cannot gain by laying off his own labor or that of his immediate family. Payments for hired labor, seed, fertilizer, and power are about the only variable costs of the farmer, and these are small compared with total costs. When the prices of his products fall, he can save comparatively little by

[11] United States Department of Agriculture, *Yearbook of Agriculture, 1935*, Washington, Government Printing Office, 1935, p. 5.

cutting down output. Indeed, falling prices for farm products, within limits, may result in increased rather than decreased farm production, since it takes more bushels of wheat or pounds of cotton to pay a given amount in taxes or interest when farm prices are low than when they are high.

The burden of fixed costs bore heavily on the farmer after World War I. Agriculture was so prosperous during and immediately following the war that farming land increased rapidly in value, and many farms changed hands at greatly inflated prices. The mortgages which usually accompanied such changes in ownership called for large interest payments and these became difficult to meet in later years. The total amount of interest payable by farmers in 1930, 1931, and 1932, was 96, 92, and 87 per cent, respectively, of the total payable by them in 1929. Similarly, the assessments on farming land for tax purposes increased during and following the war, and it was difficult, of course, to secure later reductions in these assessments. The taxes payable by American farmers in 1930, 1931, and 1932 were 100, 92, and 79 per cent, respectively, of their 1929 taxes.[12]

Thus, in the great depression following 1929, the farmers, with their fairly stable money costs and sharply reduced incomes, were in very serious straits. Thousands lost their farms through foreclosure, and the situation finally became so bad that groups of farmers sometimes banded together to prevent foreclosures and sheriff's sales, even by violence, if necessary. There were also farmers' strikes and riots, in which groups of farmers attempted to destroy farm produce on its way to the market, or otherwise to prevent the marketing of farm products until prices should improve. In some cases, crops were left to rot in the fields, or were destroyed, because they could not be sold at prices sufficiently high to cover even the necessary expenses of harvesting them. It may be argued, some years after the event, that these conditions in agriculture would eventually have corrected themselves through the action of natural economic forces. A solution of the farm problem might or might not have come about in this way. Given the best of good luck, solving the farmers' difficulties without governmental assistance would have been a long and painful process. At any rate, attempts had previously been made to give assistance to the farmers and, since the Roosevelt administration undertook to adopt a general

[12] *Statistical Abstract of the United States, 1935*, p. 590.

recovery program, it was probably necessary both economically and politically to do something about the agricultural problem.

Soil Erosion. The main farm problem, as we have already described it, was bad enough, but in later years our farmers have been menaced by a serious increase in soil erosion. While soil erosion is not of recent origin, it has only lately come to command great public attention. The extension of cultivation to new areas formerly used for grazing has stripped the soil of natural protective vegetation and, as a result, the uncontrolled forces of wind and water have severely damaged millions of acres of farming land.

In some parts of the country, the land, denuded of trees and other vegetation, is no longer able to hold the moisture which it receives at times. A considerable part of the rainfall runs off the surface, provides but little moisture for plant growth, and carries away with it many tons of fertile soil. But in the past several years soil erosion by wind has perhaps exceeded erosion by water in its destructive effects. Some of the severe dust storms originating in our western states have moved eastward to the Atlantic coast and passed out to sea, bearing with them untold thousands of tons of valuable soil whirling about in the air at a height of two or three miles.

According to government reports, soil erosion has ruined some 50,000,000 acres of farm land and badly damaged 50,000,000 acres more, and much additional land is in serious danger. Erosion dissipates fertile soil through dust storms, piles up soil on the lower slopes, spreads poor subsoil over rich bottom lands, increases the danger of floods, and robs wild animal life of essential food and cover. It also leads to the silting and sedimentation of stream channels, reservoirs, dams, ditches, and harbors, and damages roads, railways, irrigation works, power plants, and public water supplies.[13]

Soil erosion is said to be largely the result of overcropping—an unsound practice which, besides leading to erosion, makes the tillage of the soil more difficult, reduces its content of plant food, and increases the danger of drought. Depletion of the soil has been especially serious in the South, where an average of 80 per cent of the agricultural land has been kept in soil-depleting crops. Such crops as cotton and corn leave the land bare in the winter season and highly subject to erosion under the influence of the moderate climate and heavy rainfall.[14]

[13] *Yearbook of Agriculture, 1937,* p. 19 *et seq.*

[14] *Ibid.,* p. 13.

Methods have been devised for controlling soil erosion, but it is difficult to accomplish much through individual action, since the average farmer lacks the necessary skill, the financial means, and even the incentive to attempt erosion control. Since erosion is caused, or at least facilitated, by unwise use of the soil, it is directly related to the main agricultural problem. It is possible to prevent or greatly reduce soil erosion by putting land into such close-growing crops as alfalfa or bluegrass, but it is difficult for farmers to do this when their economic situation is so acute that they need all their land for money crops, such as wheat or cotton. Even the rotation of soil-protecting crops with money crops in alternate years would be helpful in checking soil erosion; but when farmers need, year after year, every penny that they can scrape together, they are likely to plant money crops continuously and let nature take its vengeance. In any case, the individual farmer usually feels that he can do little about soil erosion without the cooperation of other farmers. The methods of handling soil erosion, and the present program of the federal government, will be described later in this chapter.

Early Attempts to Solve the Farm Problem

We have seen that the farm problem was not caused by the post-1929 depression, but was merely intensified by it. Furthermore, attempts to solve the problem did not wait upon the great depression, but began to appear soon after World War I. An ineffective attempt of this kind took the form of tariff changes in 1922, which placed high rates of duty on imports of agricultural products. The avowed purpose was to protect the domestic market of the American farmer. But he already had such protection, for imports of agricultural products competing with our own had never been heavy. The protection of the home market did our farmers little good, for they were producing agricultural goods in quantities too great to be absorbed by the domestic market at favorable prices, and were rapidly losing their essential export markets. What the farmers really needed was the ability to export. The only tariff change capable of helping the farmer would have been a reduction in the tariff duties on imported manufactures, enabling foreigners to sell their goods to us and thus be in a position to buy our surplus farm produce.

Attempts to Control Surplus Production. Since the farmers were producing more than the domestic market could absorb, and were

losing their export markets, attention turned in the next few years to the question of surplus production. Two measures designed to give relief were vetoed by President Coolidge. One of these, the McNary-Haugen Act, provided that a so-called equalization fee or tax should be levied on the output of certain agricultural products, to provide funds to reimburse farmers for the losses incurred in exporting surplus farm products. This plan was expected to decrease the volume of agricultural products sold in the domestic market and maintain domestic prices for these articles well above the foreign level. The second relief measure involved what was called the debenture plan. The idea was to stimulate the exportation of farm products by granting bounties, in the form of debenture certificates, for such exports. The bounties were to equal the difference between the domestic prices of farm products and the prices received in the foreign market. The certificates were to be accepted by the federal government in payment of import duties, so that there would be a ready market for them. The purpose of this Act was, of course, to reduce the volume of farm products sold in the domestic market and thus raise prices.

The Federal Farm Board. In 1929, the Agricultural Marketing Act was passed by Congress and approved by President Hoover. The Federal Farm Board was set up to carry out the provisions of the Act, and was given one-half billion dollars for use in stabilizing the prices of farm products. While more than one course of action was open to the Board, its chief activity consisted of the purchase of a large part of our surplus output of such products as wheat and cotton, and the storage of these commodities in warehouses. For a time, the Board had some success in producing artificially high prices for these articles, but it failed eventually because it attempted to provide high prices for farm products without putting any effective check upon agricultural production. Naturally, the financially embarrassed farmers, with no restrictions on production, were stimulated by the high prices to increase their output. It seems likely that the equalization fee and debenture plans would, like the Agricultural Marketing Act, have proved defective as solutions of the farm problem.

THE FARM CREDIT POLICIES OF THE ROOSEVELT ADMINISTRATION

The Farm Credit Administration. Several steps were taken by the Roosevelt administration, in its first year in power, to provide debt relief and additional credit facilities for farmers. The Farm Credit Administration was formed in 1933 by Executive Order for the purpose of bringing a number of existing farm credit agencies under one head, and administering the emergency legislation. Operating under the Farm Credit Act, it helped farmers to develop a system of several hundred local production credit associations, to provide farmers with production and marketing credit at low cost. These associations made loans to farmers on crop and chattel security and charged interest rates of approximately 5 per cent, which was some 2 or 3 per cent less than private agencies would have charged for the same type of credit.

Emergency Farm Mortgage Legislation. As has been suggested, the farm mortgage situation during the depression was desperate. In 1932, farm mortgage debts amounted to 8.5 billion dollars, out of a total farm debt of 12 billion dollars. The total debt was more than twice the amount of the gross farm income of 1932, and about equal to that of 1929. Under the Emergency Farm Mortgage Act, the Farm Credit Administration reorganized the Federal Land Bank System and set about refinancing farm mortgage debts. The Act authorized for this purpose the issuance of two billion dollars' worth of new Federal Farm Loan Bonds, on which the federal government guaranteed interest at the rate of 4 per cent. The proceeds of the bond issue were used to make new loans to farmers or to purchase their mortgages, and some bonds were exchanged directly for mortgages.

The holders of farm mortgages, anxious for settlement after a long period of waiting, were sometimes willing to scale down their claims. Such reductions were obligatory in some cases, for the Land Bank loans, with prior liens, could not exceed 75 per cent of the normal value of the property given as security. In any event, after the mortgages were taken over by the government, the process of refinancing began. These new mortgage obligations of the farmers were to be liquidated over a long period of years, and no payments on the principal had to be made for five years. The interest charge was not to exceed 4½ per cent, as compared with 5 to 6½ per cent formerly paid by farmers.

The Mortgage Moratorium. Under the Frazier-Lemke Act, passed by Congress in 1935, a farmer, faced with foreclosure and unable to get a reduction in his mortgage obligations by direct dealings with his creditors, could apply to the courts to declare him a bankrupt. The court dealing with his case was given the power to stay all legal proceedings against the farmer for a period of three years, during which time he could retain possession and use of the mortgaged property by paying a reasonable rental. At any time during the three years, the court could order an appraisal of the mortgaged property and the farmer could obtain full title to it by paying the appraised value, regardless of the amount of the mortgage obligation. To protect the rights of creditors, it was provided that any creditor who had as security a lien on the property could demand that it be sold at public auction. In this case, the court was required to conduct such a sale after due notice, but the former owner was thereafter to be given ninety days within which he could recover full title to his property by paying the auction price, plus interest at 5 per cent.

The Commodity Credit Corporation. In late 1933, the Commodity Credit Corporation was set up for the purpose of making loans to farmers on their holdings of specified crops. It could lend a farmer 10 cents a pound on his cotton, without liability to him, if he would agree to take part in the 1934 acreage reduction program. A similar offer was made available for corn growers after the corn-hog adjustment program had been set up. That is, in states where corn could be held on the farm under seal, secured by warehouse receipts, the growers could secure a loan of 50 cents a bushel on their holdings, provided they agreed to cooperate in the agricultural adjustment program in the following year. These provisions for loans assured the growers a certain return for their products, and also enabled them to gain by any increases in prices which might result from the operation of the agricultural adjustment program.

These various credit policies were closely tied up with the main agricultural problem. With the pressure of debt obligations reduced, the farmers no longer felt it imperative to keep every possible acre of soil planted to money crops, and were willing to cooperate in a program for controlling agricultural production. Again, the crop loans to farmers made it unnecessary for them to throw their products on the market for whatever they would bring—a

course of action which could have depressed the prices of these products still further, or would at least have kept them from rising. The loans made it possible for farmers to withhold a part of their current production from the market, and thus aided the Administration in realizing its object of raising the prices of these agricultural products.

The Agricultural Adjustment Program

Parity Prices. The principal aim of the Roosevelt administration in aiding American farmers was to increase farm incomes and purchasing power by controlling production and raising prices. This objective was sought first through the Agricultural Adjustment Act of 1933, which declared it to be the policy of Congress to establish and maintain a relationship between the production and consumption of farm products which would bring the prices received by farmers to such a level as to give these farm products a purchasing power, in terms of the commodities that farmers buy, equivalent to the purchasing power of the farm products in the "base period." This period was the five years preceding World War I, or from the middle of 1909 to the middle of 1914, except in the case of tobacco. The policy was applied originally to wheat, cotton, field corn, hogs, rice, tobacco, and milk and its products, but in 1934 the list of basic products was amended to include beef and dairy cattle, sugar, peanuts, rye, flax, barley, and grain sorghums. The interests of consumers were to be protected by seeing to it that the adjustment of farm production did not raise the percentage of the consumers' total retail expenditures which farmers received above the percentage they received during the base period.

The Reduction of Output. To achieve the objects of this legislation, the Secretary of Agriculture was empowered to arrange for reductions in the output of basic agricultural commodities by making agreements with farmers to cut down acreage and paying them rentals or benefits in return for such cooperation. The amount of reduction required in the case of specific farm products, and the amount of benefit or rental payments, were to be determined by the Secretary of Agriculture. For example, the Secretary entered into some 1,010,000 contracts with individual cotton growers in connection with the 1934 crop. Every grower who accepted the plan agreed to reduce his acreage planted to cotton by not less than 35 per cent or more than 45 per cent of his average acreage during

the preceding five years; and these idle acres he leased to the Secretary of Agriculture. He promised also not to increase his total acreage of *all* crops, after deducting the contracted reduction in cotton acreage; not to increase his acreage in other "basic commodities"; and to use the land rented by the Secretary only for such purposes as might meet with the approval of that official.

In return for his cooperation in the respects outlined above, the cotton grower was to receive from the government a benefit or rental payment which would amount, on the average, to about 4½ cents per pound on the cotton which would have been grown on the land rented to the Secretary, based upon the five-year average production for 1928 to 1932. Since cotton production during this period averaged about 174 pounds an acre, this meant a payment of $7.85, on the average, per acre of land removed from cultivation. If considered as rent alone, this would have been quite a heavy payment for the land, but it was intended also to compensate cotton growers for labor and capital withheld from production. Similar programs were arranged for other basic commodities.

The Processing Taxes. To secure funds with which to administer the program and pay benefits to farmers, the Secretary was authorized to levy taxes on the processors of the basic farm products. For example, manufacturers of cotton goods were required to pay taxes based on the quantity of raw cotton entering into their products. The processing tax on each product was to equal the difference between its current average farm price and its "fair exchange value" —that is, a price which would give the seller as much purchasing power as its sale would have given during the base period 1909–14. However, if it developed that this rate of tax would not prevent the accumulation of a surplus stock of any commodity, a higher or lower tax rate could be charged.

Marketing Agreements and Licenses. As an alternative form of control, the Secretary was permitted to enter into marketing agreements with processors, associations of producers, and others engaged in handling agricultural commodities or products thereof in interstate commerce, and to require these persons to obtain licenses authorizing them to carry on their customary activities in connection with these or competing products. These licenses might be suspended or revoked for cause, and the licensees could be required to furnish detailed information as to their business transactions in these products.

The Soil Conservation and Domestic Allotment Act. In January, 1936, the Supreme Court of the United States found the Agricultural Adjustment Act of 1933 unconstitutional by a 6 to 3 vote. The Court held that the Act constituted an invasion of states' rights, since the Constitution did not give the federal government the power to regulate agriculture, and its power to control interstate commerce could not be stretched to include the regulation of agricultural production. Moreover, it was held to be improper for the federal government to purchase compliance with a federal program, and thus attain indirectly that regulation of local affairs which had been specifically denied it by the Constitution. While agriculture can hardly be considered a matter of local concern from an economic point of view, it appeared to be purely so according to this interpretation of the Constitution.

Since the federal government was unwilling to see American agriculture return to its previous chaotic state and since no permanent solution of the farm problem had been found, the government launched forth upon the discovery of a new farm program. In its search, it soon came upon the problem of soil erosion, upon which we commented earlier in this chapter. Satisfactory methods of combating soil erosion had been developed. Several types of close-growing vegetation, such as grass and alfalfa, are helpful in holding the soil in place and reduce water and soil losses very materially. Amazing results may be achieved merely by rotating such soil-conserving crops with the money crops, such as corn and cotton.

A method known as strip-cropping is also helpful in preventing soil erosion under favorable conditions of cultivation. Strip-cropping means the alternation of close-growing crops with the money crops in strips of a certain width, depending on the degree of slope and other factors. This method of controlling soil erosion often requires help from other mechanical methods, especially on the steeper slopes, for land is in danger of erosion whenever it is planted to cultivated or money crops. In such cases, methods such as terracing the land and using broad, contoured channel ways for drainage have often proved helpful in reducing sheet erosion and severe gullying.

The chief difficulty with erosion control in the past was to get the farmers actively interested in it. The individual farmer often felt that he could do little about soil erosion by himself, or he lacked the financial resources which would permit him to make the at-

tempt. Under unfavorable farm conditions, the farmers often considered it necessary to use almost all their land for money crops and to keep it planted to such crops year after year, in order to make ends meet. In 1936, after the A.A.A. was declared unconstitutional by the Supreme Court, the government decided to undertake a program of erosion control which would also help to solve the main farm problem.

Consequently, in February, 1936, a previously existing Soil Conservation Act was amended and enlarged to become the Soil Conservation and Domestic Allotment Act. The Act authorized the Secretary of Agriculture to restore the pre-war relationship between farm and city incomes for those farmers who agreed to practice specified methods of soil conservation and erosion control. Two classes of benefit payments were made available for farmers who cooperated. Payments for soil conservation were granted to farmers for transferring a part of their soil-depleting base acreage to soil-conserving crops or uses, and other soil-building payments were made available for farmers who adopted certain approved practices to restore soil fertility, such as new seedings of legumes or perennial grasses; seedings of soybeans, cowpeas, and the like, for green manure; and the use of strip-cropping or terracing methods. The relation of this conservation program to the main farm problem is obvious. If the farmers used part of their land for crops which would be effective in preventing soil erosion, they could not use it for producing the basic money crops. In this way it was planned to kill two birds with one stone—to achieve some highly desirable results by way of controlling soil erosion, and at the same time to prevent the overproduction of the basic crops.

The Agricultural Adjustment Act of 1938. The soil conservation features of the Act of 1936 were undoubtedly desirable, but the Act proved rather ineffective in controlling agricultural production. By 1938, the prices of basic products had slumped badly, large surpluses were on hand, and additional large crops were in prospect. As a result, Congress passed the Agricultural Adjustment Act of 1938 in February of that year. The Act provided for the continued operation of the Act of 1936, and its payments to farmers, in normal times. In years of overproduction, however, rather stringent methods of control were to go into effect.

Control of agricultural production was carried on by means of acreage allotments, marketing quotas, and commodity loans. The

acreage allotments were not compulsory in themselves, but they furnished the basis for setting up marketing quotas, and farmers who produced and sold the basic products in amounts exceeding their quotas could be made to pay penalties on the excess. The national acreage allotment for each commodity was made by the Secretary of Agriculture, and was the acreage estimated to be necessary to produce a normal year's requirements for consumption and export, plus an arbitrary amount for stocks, minus the amount carried over from the preceding year. The total acreage allotment was then divided among states, counties, and individual farms. Farmers who stayed within their allotted acreages received cash benefits from the government, in addition to the benefits of the soil conservation program.

According to the Act of 1938, there was "overproduction" whenever the supply (crop and carry-over) of a basic product exceeded "normal" by more than a stated percentage. For cotton, overproduction was any amount in excess of 107 per cent of normal; for wheat, 135 per cent; for corn and rice, 110 per cent; and for tobacco, 105 per cent. "Normal" in each case was the amount estimated to be necessary for a year's consumption and exports. When there was overproduction of any of the basic commodities, the Secretary of Agriculture could set up compulsory marketing quotas, but such quotas did not become effective until approved by two-thirds of the producing farmers voting in a referendum. The total marketing quota was prorated to states, counties, and individual farms in proportion to the normal yields of their acreage. For the individual farmer, the marketing quota was the amount of a commodity that he could sell without incurring penalty. Basic commodities produced in excess of marketing quotas could not be fed to livestock for the market, given away, or traded for other economic goods. To avoid penalties, they had to be stored on the farms or in warehouses.

The Act of 1938 provided for loans to farmers to enable them to carry adequate reserves of basic products as a safeguard against lean years. The Commodity Credit Corporation was required to make loans on cotton, corn, and wheat, under conditions laid down in the Act, and could lend on any agricultural commodity. No loans could be made on cotton, corn, wheat, or rice in years in which marketing quotas had been declared necessary but had been rejected by vote of the farmers concerned. In general, loans were to

be made whenever the price of a basic commodity fell below a specified percentage of parity, or when the crop estimate exceeded a normal year's consumption and exports. The parity price for a good, as under the original Agricultural Adjustment Act, was defined as one which would give that commodity a purchasing power (in terms of goods that farmers buy) equal to its purchasing power in the base period which, for most of the goods, was the period from 1909 to 1914. Minimum loan rates were set by the Act at 52 per cent of parity prices. Farmers who did not cooperate in the quota program could receive loans only in years in which marketing quotas were in effect, only on portions of their crops whose sale would not be subject to penalties under the marketing quotas, and only at rates which were 60 per cent of those extended to cooperating producers.

Evaluation of the Agricultural Adjustment Program

The Agricultural Adjustment Act of 1938 had been in effect only a relatively short time when World War II broke out, and long before that conflict was over the main farm problem became one of securing adequate agricultural production instead of one of restraining production and avoiding large surpluses of basic farm products. Before examining the status of agriculture in the war period and its prospects for the future, it will be desirable to evaluate the Agricultural Adjustment Program as it operated from 1933 to 1940.

Gains for Farmers. The Agricultural Adjustment Program was successful in securing reductions in the acreages devoted to the basic crops and, with the help of other factors, such as weather conditions, it raised the prices received by farmers for these products. In 1932, as we have noted, prices received by farmers stood at 68 (1909–14 = 100) while prices paid by farmers were at 124. By 1937, prices received by farmers had advanced to 122, while prices paid by farmers had increased only to 133.[15] The ratio between these indexes was then 92, a level which had not been exceeded since 1920. At the same time, income from agriculture, which had amounted to only $3,040,000,000 in 1932, increased to $6,802,000,000 in 1937.[16] Both agricultural prices and income, however, were considerably lower from 1938 to 1940 than in 1937.

[15] National Industrial Conference Board, *The Economic Almanac for 1945–46*, p. 170.
[16] *Ibid.*, p. 168.

The Prevention of Production Adjustments. In spite of these gains for American farmers, the operation of the Agricultural Adjustment Program was subject to a number of serious criticisms, several of which related to the attempt to secure and maintain rigid parity prices for farm products. The base period for parity prices goes back to the years 1909 to 1914 for a number of products, and the maintenance of parity prices disregards changes in relative costs of production which have occurred since that time and tends to prevent needed readjustments of agricultural production. For example, 89 man-hours were required to produce 100 bushels of wheat in the base period, and only 41 man-hours in the 1934–36 period. Again, the use of hybrid varieties of corn increased yields by 15 to 20 per cent with only a small increase in costs.[17] On the other hand, increases have occurred in the labor requirements and cost of production for such things as vegetables.

In such a situation, parity prices treat the growers of some products much better than the growers of others. Even under parity prices, it becomes difficult to get adequate production of some crops whose costs have increased and, unless production control is very severe, it is difficult to hold down the production of others. If the government is to maintain prices for agricultural products, these prices should be kept flexible, so that they will reflect the changes which occur in relative costs of production and will not interfere with necessary adjustments of production.

If the production of some basic crop is to be curtailed, it would seem desirable to let low-cost producers turn out as much as usual, while eliminating certain high-cost producers entirely. However, the Agricultural Adjustment Program sought curtailed production and parity prices through percentage reductions in acreage on the part of all growers of a crop who were willing to participate in the Program. This meant, quite simply, that high-cost areas were kept in production at the same time that production was being curtailed in lower-cost areas, and the Program prevented desirable basic adjustments in production from taking place.

Exports and the A.A.A. While the Agricultural Adjustment Program did not succeed immediately in raising the prices of farm products to a parity level, a considerable increase in these prices did occur under its auspices and the prices rose to a level well above

[17] Board of Governors of the Federal Reserve System, *Agricultural Adjustment and Income,* p. 14.

those prevailing in the rest of the world. This situation resulted in a low level of agricultural exports, and indirectly operated to restrain exports of manufactured goods which required the use of these high-priced farm products as raw materials. Moreover, any attempt to sell farm products abroad at prices lower than those prevailing in the United States was likely to be regarded as "dumping" from the point of view of other countries and to lead to antagonism and retaliation on their part. Thus the operation of the Agricultural Adjustment Program seemed to be in direct conflict with the Roosevelt administration's objective of producing an increase in the volume of our international trade. The disappearance of American farm products from world markets also produced some increases in world prices of the products, and tended to encourage the expansion of production in other countries.

This problem is likely to remain troublesome in the post-war period. For example, "Brazilian cotton Type 5 at the São Paulo market averaged 0.53 cents above the American Middling 15–16 at New Orleans from 1923 to 1929. From December, 1941, to July, 1945, the American domestic price has exceeded the Brazilian by from 6 to almost 12 cents per pound; a number of countries have shifted their purchases from American to Brazilian cotton partly because of relative prices and partly because of shortages of dollar exchange. While the United States was reducing the cotton acreage, Brazil almost tripled her acreage from the 1930–34 average of 2.4 million acres to 6.7 million in 1940." [18]

The Efficiency of Production Control. The success and cost of a policy of maintaining rigid parity prices for farm products depend to a great extent upon the efficiency of methods of controlling farm production, and the Agricultural Adjustment Program was not very successful in this respect. The lowest point reached by the index of the physical volume of farm production (1909–14 base) was 111 in 1935, and the index reached a new high point of 128 in 1937.[19] The Program succeeded in reducing the acreages devoted to the basic products, but production remained high and later increased because of increased yield per acre. In the case of corn, for example, an average acreage of 108 million acres was maintained from 1931 to 1933 and production averaged 2.6 billion bushels. In the period from 1939 to 1941, the area devoted to corn averaged only 87 million acres under the A.A.A., but production still averaged 2.6 billion

[18] *Ibid.*, pp. 15–16. [19] *Ibid.*, pp. 3, 12.

bushels.[20] The greatly increased yield per acre resulted from the use of hybrid varieties of corn and improved crop rotation.

In order to curtail the *production* of a given crop by a certain desired percentage, it is necessary to achieve a much greater percentage reduction in *acreage,* both because the land taken out of production will be the poorest land and because land used for producing the controlled crop is likely to increase in productivity as it is rotated between the controlled crop and other soil-building crops. The A.A.A. had serious difficulties, therefore, in controlling production when only a few basic crops were involved. The problem would be much worse if almost all phases of farm production had to be controlled. Farmers do not like to have their land and other resources lie idle. If they reduce their production of some crops, they are likely to increase their production of others. If the production of almost all farm products were controlled, there would be almost no place for the farmer to turn with any acres dropped from the production of a given crop; and it might be very difficult to maintain farmer participation in and compliance with the governmental control program.

Income and Standards of Living. The Agricultural Adjustment Program, in the period from 1933 to 1940, was not especially effective in increasing the income and efficiency of low-income farmers. In the year from July 1, 1935, to June 30, 1936, a year between the great depression and the prosperous war period, almost one-fourth of American farm families received less than \$500 of income, about 38 per cent received less than \$750, and only 8 per cent received more than \$2500.[21] These figures included the rental value of the farm homes and the market value of farm products consumed on the farms. In other occupations in the economic system, only 16 per cent of the workers received less than \$750 in the year in question, and 17 per cent received over \$2500.[21] Even in 1942, only 18 per cent of total agricultural income went to the 50 per cent of the farmers with lowest incomes.[22]

Progress Toward the Controlled Economy. The Agricultural Adjustment Program tended to bring an ever-increasing number of farm products under price and production control. Starting with a few basic products, the Program spread to others because the farmers, as they reduced the acreage devoted to the controlled crops, planted their land to other crops and created "overproduc-

[20] *Ibid.,* p. 16. [21] *Ibid.,* p. 4. [22] *Ibid.,* p. 18.

tion," surpluses, and low prices for these other products. It seemed that there would be no logical end to this process short of complete and strict governmental control over agricultural production in general. Indeed, some people feared that the controls would spread to manufactured products made from basic farm materials, to other products competing with these manufactured goods, and so on, until eventually a planned and controlled economy of socialism would be the result. Without altogether accepting this point of view and without any intention of arguing the relative merits of capitalism and socialism at this time, we may yet conclude that the development of stringent governmental control over agricultural production and prices would be a step in the direction of a controlled economy of some type or other.

The Permanence of the Farm Program. One of the most serious criticisms of the farm program was the charge that the A.A.A., once instituted, could not be given up and would become a permanent policy. It can scarcely be stated too emphatically that the Agricultural Adjustment Program was not desirable as a permanent solution of the farm problem in the United States, because it did nothing to reduce the number of farmers in the country or the amount of land available for the production of the basic crops. When the demand for a manufactured product suffers a permanent decline, the industry reacts by producing fewer units than formerly and by allowing a part of its productive facilities to lie idle. Eventually, however, the industry tends to readjust its productive capacity to the changed conditions of demand, and only then can it be said to have met the problem created by the decline in demand. The Agricultural Adjustment Program led only to the first of these steps; that is, it induced the farmers to produce less than before and to allow part of their productive agents to remain unused. It did not lead to the apparently necessary curtailment of the land, labor, and capital employed in the agricultural industry.

In the period under discussion, 1933–40, A.A.A. payments to cotton farmers amounted to 1.3 billion dollars, which was over 25 per cent of the value of the cotton lint produced in this country during the period.[23] Even if we admit that doing nothing about prices and production would have been too slow and painful a method of forcing high-cost farmers to turn to some other type of farming, it is still reasonable to think that the government's money

[23] *Ibid.*, p. 15.

could have been spent in a more useful way over the period. That is, if the 1.3 billion dollars had been spent in adjusting the size of farms in the cotton-raising area, training the farmers to carry on a diversified type of agriculture, and lending them the funds necessary to effect the transformation, we might well have been closer to a permanent solution of the cotton section of the farm problem by 1940.

Despite the fact that many if not most people felt that the A.A.A. should be merely a temporary program, there was always a possibility that it might be continued indefinitely. Once the government had established the practice of paying cash benefits to the farmers, it threatened to be a most difficult matter, from a political point of view, to discontinue these benefits when it became economically desirable to do so. Hence, we were in some danger of seeing the farm program remain as an undesirable but permanent feature of our economic system, in much the same fashion that the protective tariff, created more than a century ago to protect infant industries, has remained to plague us long after some of these infants have become industrial giants.

The Status of Agriculture During World War II

Demand and Production. In the period of World War II, American agriculture was faced with an unprecedented demand for its products for use at home and abroad, and it responded nobly to this demand. In fact, agricultural production increased more rapidly during this war than during World War I. The index of agricultural production (1935–39 = 100) rose rapidly from 110 in 1940 to 136 in 1944 and 130 in 1945.[24] These results were achieved in spite of the fact that there was a severe shortage of new agricultural machinery and equipment, and that much labor was drawn from agriculture into other branches of production and into the armed forces. We had large stocks of grain on hand at the beginning of the war period, which made possible a rapid expansion in livestock production. Our farms were already so thoroughly mechanized that crop acreages could be expanded or at least maintained in the face of shortages of new equipment and labor; and unusually favorable weather conditions also played a part in increasing production.

Prices and Income. The prices of agricultural products were brought under price control at a later date than the prices of most

[24] *Ibid.*, p. 6, and *Survey of Current Business*, February, 1946, p. 15.

other things, and they rose rapidly during the war period. The prices *received* by farmers became higher than the prices *paid* by farmers in 1942 for the first time since 1920. By 1944, the index of prices received was 195, and that for prices paid was 170.[25] This meant that the farmers, by giving up products worth $1.00 in the base period (1909–14), could secure products valued at $1.15 in the base period. The prices of farm products rose another 4 per cent in 1945. With both farm production and prices rising, the incomes of the farmers underwent an exceptional expansion in the war period. Cash income from farm marketings and government payments, which had amounted to $9,106,000,000 in 1940, increased to $20,594,000,000 in 1944 and to $22,000,000,000 in 1945.[26] These latter amounts were new all-time records.

Production Controls. In the war period, the agricultural problem was to secure enough farm products rather than to restrain production and prevent surpluses, so the various controls provided by the Act of 1938 could be largely relaxed. However, payments to farmers under the Soil Conservation and Domestic Allotment Act of 1936 went forward as usual during the war period. In addition, it was thought necessary to take certain steps to stimulate agricultural production. The most important of these was a series of Acts which placed price floors under agricultural products and promised a continuance of parity price guarantees into the post-war period. Prices of cotton were to be guaranteed at 92½ per cent of parity, and those of wheat, corn, tobacco, peanuts, and rice at 90 per cent of parity, for two years after January 1 of the year following the official declaration that the war had been terminated. A guarantee of prices at 90 per cent of parity for the same period after the war was extended to a number of agricultural products not included in the above list of basic products, provided funds were available for the purpose when the time came.

Future Agricultural Policy

From the point of view of our needs during World War II, it was probably fortunate that a genuine reduction in the productive capacity of agriculture was not achieved during the 1930's, for we needed, at least temporarily, all the products which the industry

[25] National Industrial Conference Board, *The Economic Almanac for 1945–46*, p. 170.

[26] *Ibid.*, p. 168, and *Survey of Current Business*, February, 1946, p. 16.

could turn out. However, it would not be sound economic policy to keep agricultural capacity at an excessive level for decades at a time on the chance that we might need all of this capacity if a major war occurred. Since the productive capacity of agriculture was regarded as excessive even before World War II and since the war period brought great increases in agricultural production and added many acres to the area under cultivation, there is serious question as to what the status of American agriculture will be in the post-war period. Are we not likely to be troubled again with "overproduction" and growing agricultural surpluses, falling prices for farm products, and declining agricultural income?

Full Employment and Economic Stability. Under certain conditions it is possible that there will be no agricultural problem in the United States in the post-war period. One thing which would help greatly in preventing the development of such a problem would be the maintenance of a high and stable level of production, employment, and income in the economic system as a whole. As we have seen, agricultural production in general is remarkably stable through good years and bad, and has changed sharply only in wartime. Hence, agricultural production is not an important factor in producing booms and depressions in general business, though agriculture suffers heavily as a result of instability in the economic system as a whole. If the general level of economic activity in the country could be kept high and stable, there would be little need for special aids to agriculture. Consequently, agriculture must regard with great interest any plans which are made for stabilizing production and employment in the United States at a high level.

Agricultural Exports. Another factor which would be helpful is the development of export markets for farm products. During the war, American agriculture was producing for both this and other countries, and our exports of farm products were abnormally large. It seems clear that, in the post-war period, agricultural production is likely to exceed the needs of the domestic market by a considerable amount. Our imports of agricultural products may increase to the pre-war level, individuals returning to civilian life from the armed forces may consume less food than formerly, manufactured goods will be available in larger quantities than during the war period, and people may not care to spend as great a proportion of their income on food as they did during the war years. Therefore, the need for agricultural exports will be great if farming is to oper-

ate at capacity. If such organizations as the International Monetary Fund, the International Bank for Reconstruction and Development, and the Economic and Social Council of the United Nations work successfully and produce a greatly enlarged volume of international trade in the post-war period, the result is likely to be highly beneficial for American agriculture.

The Maintenance of Adequate Diets. Agriculture would also profit from the attainment and maintenance of an adequate diet for the people of the country as a whole. It would be best, of course, if production, employment, and income could be kept at such a high level that the people could provide themselves with adequate diets through the purchase of farm products. In the absence of such a happy situation, the subsidization of food consumption for low-income families and the improvement of their diet not only would benefit national health and efficiency but would help to dispose of agricultural surpluses and raise the prices of agricultural products. Too much should not be expected from this source, however. It has been estimated that the provision of adequate diets for all low-income families in the country would absorb the production of only about five million acres of farm land over and above the acreage which would otherwise be necessary.

Monopolies and Agriculture. It seems, finally, that the status of agriculture in the post-war period will depend to some extent upon the success which attends our efforts to deal with the problem of monopolies and trusts. In the past, our farmers have been handicapped by having to sell their products in a highly competitive market while doing most of their buying in a market which was to a considerable degree controlled by monopolists, oligopolists, and monopolistic competitors. In the long period of good business prior to 1929, many of our manufacturing industries, being monopolistic or semi-monopolistic in character, were able to maintain stable prices in the face of improved methods of production and falling costs of production. Quite apart from the effect of this situation in producing the great depression, it made it difficult, if not impossible, for our farmers to get prices for their products which would enable them to share in the general prosperity of business.

Later, after the great depression broke in 1929, these monopolistic and semi-monopolistic industries were still able to maintain prices to a very considerable extent. This they did by restricting production sharply, by turning off employees, and by reducing their pur-

chases of raw materials. This course of action made it difficult for farmers to sell their raw materials and foodstuffs, and the uncontrolled prices of farm products had to bear the brunt of the depression liquidation. Thus, in a sense, the farmers under the Agricultural Adjustment Program were only giving our industrialists a taste of their own medicine, with the assistance of the government. The farm problem would have been much less severe in the past if competitive conditions had been maintained in industry, and it would be much less likely to reappear in the post-war period if the monopoly problem could be solved.

Forward Price Floors. While a happy combination of circumstances might forestall the reappearance of the farm problem in the post-war period, we cannot count on this result being attained. If worst comes to worst and general economic conditions remain unstable, agricultural exports decline to the pre-war level, agricultural surpluses reappear, and farm prices and income threaten to fall disastrously, governmental aid to agriculture will again be necessary. What form should it take? The most reasonable suggestion we have encountered is the establishment of forward price floors.[27]

According to this proposal, an Agricultural Price Board (to be created by act of Congress) would set up price floors extending over one production period for the various farm products. Such floors would protect farmers against collapsing prices of farm products in any one year, and would enable them to plan production intelligently on the basis of foreknowledge of the relative prices of various products. The Board would try to establish its price floor for each commodity at such a level that market demand for and market supply of the good would be in equilibrium at that price.

In order to reach this objective and to free the Board from pressure from special interests in agriculture, the Board's freedom of action would be limited by a number of regulations. In the case of export commodities, the price floors established by the Board should not be allowed to exceed the world prices expected for the commodities during the forthcoming year. In the case of nonperishable products, the Board should be required to lower the price floor for any commodity in the year to come when the carry-over exceeded an established "normal" by 10 per cent, and to raise the price floor when the carry-over was 10 per cent below "normal."

[27] As discussed in Board of Governors of the Federal Reserve System, *Agricultural Adjustment and Income,* pp. 28–31.

In the case of perishable products, the Board should be required to lower the price floor for the coming year whenever it had been necessary for the government to purchase a farm product in the open market and resell it at a loss. Finally, the price floor for any commodity should be raised in the coming year if its price exceeded the existing floor by 10 per cent.[28] In all cases, the prices of farm products would be kept from falling through the floors by means of the power of the Board to have the Commodity Credit Corporation purchase the products and either store or resell them at a loss. Since this action would necessitate lower floors in the following year, the program would not result in the maintenance of rigid prices for farm products or become excessively costly.

The program of using forward price floors would be superior in several respects to the continued use of a program for maintaining rigid parity prices based on a distant historical period. First, while fears of collapsing prices of farm products in any given year would be eliminated, the prices of individual farm products would be completely flexible in the long run. That is, even though price floors were used from year to year, the prices of some individual farm products could fall while those of others rose, as the costs of production changed in the various fields of agricultural production. Second, the program of forward price floors would not require direct and severe control of agricultural production by the federal government. Third, the program could be modified to provide for the special conditions prevailing in times of depression without producing rigidities which would later become difficult to eliminate.

In this last connection, the Board could be directed not to permit the price of any agricultural commodity to fall in a given year by more than 20 per cent of the average price in the preceding three years. Under this provision, five years of depression would be necessary to reduce the price of a farm product to 54 per cent of its pre-depression level. It is estimated that, if this system had been in operation, the prices of agricultural products would have fallen by only 20 per cent, instead of 40 per cent, between 1920 and 1921, and by 32 per cent, instead of about 55 per cent, between 1929 and 1932.[29] The decline in the prices of farm products during a depression would be controlled through purchases of the products by the Commodity Credit Corporation for resale at a loss.

[28] These suggested regulations are from *ibid.*, p. 29.
[29] *Ibid.*, p. 30.

This method of helping the farmers in depression periods would keep agriculture from bearing more than its share of the burden of depression. It would maintain the farmer's income through the prices received for his products instead of by direct subsidies or "benefit" payments. It would be relatively simple in operation and would go into action automatically when needed. Its cost could be financed in a way which would not curtail purchasing power elsewhere in the economy. It would permit lower prices of farm products to ultimate consumers and would not curtail production in non-agricultural fields. Finally, it would permit the prices of individual farm products to remain flexible in relation to one another.[30]

Other Policies. While the system of forward price floors was being applied to the main agricultural problem in the post-war period, other governmental agricultural policies might also be desirable. The soil conservation program should be continued, but it should be based on the physical necessities of soil conservation and not be a device, as in the past, for helping to control agricultural production. The production of individual farm commodities should depend on demand and supply (cost) situations, and the soil conservation program should be adjusted to the crop pattern which results. Crop insurance, to protect the farmer against the uncontrollable risks of his industry, began in a small way under the Agricultural Adjustment Act of 1938, was later repealed, and was reenacted in 1945. This system might well be extended in the post-war period. Finally, some measures for the reduction of agricultural poverty might be tried, for this problem remains even in years of generally high farm prices and income. The measures might include enlarging the farms used by low-income farmers, training these farmers for greater efficiency, making capital funds available to them, and possibly training some of them, who must leave agriculture, for jobs in other fields.

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1. Indicate the importance of agriculture in our economic system.
2. In what sense has the problem of agriculture been one of overproduction? Explain.
3. Why did American agriculture expand production during and immediately after World War I? Explain.
4. What happened to agricultural prices and income during World War I?

[30] *Ibid.*, pp. 29, 30.

5. Discuss the demand and supply conditions which existed for agricultural products during the 1920's.
6. How did agriculture fare in the great depression following 1929?
7. How did the behavior of agricultural output and prices in the great depression differ from that of output and prices in certain manufacturing industries?
8. Explain fully what is meant by "the insensitiveness of farming."
9. "The burden of fixed costs to the farmer grew heavier during the depression." Explain.
10. What is the nature of the problem of soil erosion? How is this problem related to the main agricultural problem?
11. Were American farmers benefited by the high tariff rates placed on imports of farm products in 1922? Explain.
12. How were the equalization fee and debenture plans expected to help the farmers? Explain.
13. Discuss the Federal Farm Board experiment.
14. Outline the farm credit policies of the Roosevelt administration.
15. What was the relation of farm credit policies to the main agricultural problem? Explain.
16. What was the purpose of the Agricultural Adjustment Act of 1933? Explain.
17. What were the principal methods by which this purpose was to be accomplished? Explain.
18. Explain the dual purpose of the Soil Conservation and Domestic Allotment Act of 1936.
19. Why was additional farm legislation passed in 1938? Compare the provisions of the Agricultural Adjustment Act of 1938 with those of the Act of 1933.
20. Indicate the extent to which the status of agriculture improved under the Agricultural Adjustment Program from 1933 to 1940.
21. Why is it said that the Agricultural Adjustment Program prevented necessary or desirable adjustments of agricultural production? Explain.
22. How were agricultural exports affected by the Agricultural Adjustment Program? Explain.
23. Was the Agricultural Adjustment Program successful in reducing agricultural production? Explain.
24. Did the Agricultural Adjustment Program succeed in raising the income and efficiency of low-income farmers?
25. Was there danger that the Agricultural Adjustment Program might lead the United States to complete socialism? Explain.
26. "The greatest danger of the Agricultural Adjustment Program was that it would become a permanent program even though it did not furnish a satisfactory long-run solution for the main farm problem." Explain.
27. "The period of World War II was one of great prosperity for American agriculture." Explain.

28. Is it likely that the main farm problem of the 1930's may reappear in the post-war period?
29. What are the conditions under which there might be no agricultural problem in the post-war period? Explain.
30. If governmental assistance for agriculture is necessary in the post-war period, what form should it take?
31. Discuss the ordinary operation of a program of forward price floors for agricultural products.
32. What are the advantages of such a program as compared with one for the maintenance of rigid parity prices? Explain.
33. How could a program of forward price floors be used to control the decline of agricultural prices and income in periods of depression? Explain.
34. What would be the advantages of this program for aiding agriculture in depression periods?
35. What types of agricultural assistance might the government provide in the post-war period besides the operation of a system of forward price floors? Explain.

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21. Transportation

Specialization and large-scale production are fundamental characteristics of the present economic order. An individual does not attempt to produce for himself all of the many economic goods he needs for the satisfaction of his wants, but instead specializes in a single task or a limited number of tasks, trusting that he may obtain, through the process of exchange, the other economic goods that he desires—goods which have themselves been produced for the most part on a large scale by other groups of specialists. Large-scale production brings with it many economies, but we often hear it said that the extent to which large-scale production (and its accompanying principle of division of labor) can be applied is largely limited by the size of the market for the products. The extent of the market is in turn greatly dependent upon the adequacy and efficiency of the means of transportation which have been or can be developed.

The Importance of the Railroads. In the United States, as in other industrially advanced countries, the railroad has for many years been the most important single means of transportation. In 1944, there were 227,335 miles of railroads in this country, counting only the first main track between any two points. If second, third, fourth, and other trackage is included in the total, the figure for 1944 was 377,210 miles. The total reported property investment in our railroads amounted to over 26½ billion dollars in 1944. In the same year, the Class I railroads (which means every railroad that has a net operating revenue of at least one million dollars per year) employed 1,414,776 workers on the average, carried revenue freight amounting to 740,586,000,000 ton-miles, and provided passenger service to the extent of 95,663,000,000 passenger miles.[1] In 1944, the railroads carried 69.92 per cent of all the freight, express, and

[1] These statistics are from the *Fifty-ninth Annual Report of the Interstate Commerce Commission*, Washington, Government Printing Office, 1946, pp. 133–137.

mail transported in the United States (in terms of ton-miles), as compared with 13.04 per cent for inland water carriers, 12.41 per cent for pipe lines, 4.62 per cent for motor carriers, and .01 per cent for airways.[2]

Clearly, it is important to everyone that an industry of such magnitude and vital significance in our economic system should be kept strong and vigorous, and capable of rendering cheap, efficient service. And yet, for many years between 1929 and the beginning of World War II, our railroads experienced great difficulty in earning sufficient net revenue to enable them to maintain existing plant and equipment satisfactorily and to attract enough new funds to make possible the construction projects and betterments which were necessary for continued efficient operation. Indeed, many roads failed to meet their obligations and went into receivership, and our railroads as a whole operated at a net deficit, after paying interest charges, in certain years. How were the railroads brought to such a condition? What can be done to improve their lot? How will they fare now that the prosperous wartime period is over? These are questions which we examine in the present chapter; and in doing so, we shall find it necessary to inquire into the affairs of the other forms of transportation in the United States. Our first task, however, is to consider the chief economic characteristics of the railroads.

Economic Characteristics of the Railroads

The railroads furnish an outstanding example of an industry which tends naturally to become a monopoly. That is, the railroad industry is one in which free competition is wasteful, if not actually ruinous, and in which maximum efficiency and lowest costs of production can be obtained only when competition is eliminated or at least greatly restricted.

Increasing Returns in Railroading. One of the characteristics of railroads upon which the tendency to monopoly depends is what is usually called increasing returns. A railroad is a business that requires a heavy original investment. The interest upon borrowed capital, together with other fixed charges such as the rentals of leased lines, taxes, and amounts to be set aside for sinking funds to provide for maturing obligations, make up an important part of total costs of transportation, and a part which remains the same whether the railroad runs at full capacity or at only part capacity. As the

[2] *Ibid.*, p. 13.

traffic handled by a railroad increases, the operating costs increase, of course, but total costs do not increase in proportion to the increase in traffic, because of the large element of fixed costs. It follows, then, that as a railroad comes to be operated at full capacity, instead of at half capacity, the business that is handled doubles but the costs of transportation do not double, and, if the rates charged are assumed to be relatively constant, net earnings of the railroad increase.

There is nothing mysterious about the tendency described in the preceding paragraph, nor is the tendency peculiar to the railroad industry. Any industry which has a considerable amount of plant and equipment will find that it is more economical to run at or near full capacity, rather than at some lower level. Nor should one be led to jump to the conclusion that the railroad is necessarily one of those industries which are characterized by economists as "industries of decreasing costs." The concept of decreasing costs, as usually described in connection with price determination in the long run, is concerned with the average cost per unit of product which the industry would experience as it adjusted itself to different volumes of production *through changing the amount of plant and equipment* and other productive factors devoted to production. Thus, an industry which would have a lower average cost of production per unit when its productive capacity and amount of plant and equipments used were large than when capacity and amount of plant and equipment were small, is to be described as an industry of decreasing costs. But, with either a large or a small amount of plant and equipment, any concern in the industry would find it more profitable to run at full than at part capacity, and would experience increasing returns in the sense that a railroad may experience them. The concept of decreasing costs, therefore, refers to the experience of an industry as a whole as it changes its productive capacity, while the concept of increasing returns as applied to the railroads refers to the experience of one concern in an industry as it more or less completely utilizes a given amount of productive equipment. It may be that the railroad fits into both classes, but the one does not follow from the other.

However, the tendency to increasing returns, as described above, is of particular importance in railroading, because it is more pronounced in the railroad business than in most other lines of production. As a result of this tendency, any gain in the volume of business handled is welcomed by a railroad, while any loss of traffic is

serious matter; and consequently, under a system of competitive rates, a wild struggle for traffic usually ensues.

Joint Costs in Railroading. A second important characteristic of the railroad business is that it operates under conditions akin to those of "joint costs." A railroad, of course, ordinarily furnishes only a single service, transportation; but a given train often carries a wide variety of articles—some of high and others of low value; some in carload lots, others in less than carload lots; some for long distances and others for short distances. The result is that the exact cost of a given unit of transportation cannot be discovered. What part of the total cost of operating a train for an 800-mile run, for example, should be charged to a ton of coal which is being carried for 63 miles in conjunction with 80 or 90 cars full of other commodities, of different values per pound, being carried for different distances, in lots of different sizes? It follows, then, that the rates charged by railroads for their services in connection with any particular lot of goods must be more or less arbitrary, being based upon a notion as to "what the traffic will bear" rather than upon actual unit cost of production of the service.

We have already shown that the tendency to increasing returns in railroading appears most clearly when a larger volume of traffic than formerly handled is carried at approximately constant rates. Under conditions of competition, however, it does not take a railroad long to discover that it will be wise, at least from the short-run point of view, to add to its volume of traffic even if it has to reduce rates to attract the new business. As long as any new traffic will bring in enough revenue to cover the special costs of handling it, and in addition contribute something toward the costs which would persist whether or not the new business is taken on, it is profitable for a railroad to go after new traffic. Unfortunately, however, rate-cutting does not usually stop with the first cut. Unless the road with the increasing traffic has really attracted some business which would not otherwise have been carried, it has increased its own traffic at the expense of some other railroad or railroads, and one cut in rates usually leads to another, until business is being carried at rates insufficient to cover even the operating costs, not to mention the fixed costs. This process of competitive rate-cutting has often been described as "cut-throat competition."

The Development of Railroad Regulation

The American Railroad Industry Under Competition. In spite of the fact that the railroad industry is one in which competition tends to be wasteful, the construction and operation of railroads in this country went on under conditions of practically unrestricted competition for more than fifty years. Railroads were built far in advance of the needs of the territories to be served by them, and the pressure upon the railroads, with their large unused capacities, to go out and get business, at whatever cost, was irresistible. The result was severe and destructive competition, and rate wars were of frequent occurrence. In addition, certain other pernicious practices, such as local and personal discriminations, sprang up.

Local Discrimination. The most important type of local discrimination was that in which a given shipment of goods would be carried a long distance at a lower rate than that charged for carrying it a shorter distance. For example, as between New York City and Chicago, a low rate on a given commodity would be likely to prevail because of competition among several railroads operating between these two great terminals, while a railroad would charge a higher rate on this same good as between New York and some intermediate point at which competition with other railroads did not exist. Sometimes the rate charged to the intermediate point was the sum of the through rate from New York to Chicago and the local rate from Chicago back to the intermediate point. So long as the through or competitive business paid for the special costs of handling it, and contributed something to the other transportation costs, it was profitable for the railroad to take it. Moreover, the rates to the local or intermediate points would not usually have been lowered if the railroad had given up the competitive business, for the local traffic would then have had to bear both the operating costs and the fixed costs in their entirety, whereas the through or competitive traffic contributed something toward the fixed costs.

Personal Discrimination. The pressure to get business, when railroads had unused capacities, manifested itself also in personal discrimination, which means charging one person more than another for substantially the same service, or giving one person more service than another while charging the two the same rate. Favors of this sort were granted by means of a great many devices which are too numerous to note here, and were accorded chiefly to the more powerful shippers, that is, to those who had the largest quantities

of commodities to be transported. The effect of widespread personal discrimination is to reduce the railroads from the status of common carriers to that of contract carriers, or carriers which undertake each particular bit of transportation service on the basis of a separate agreement as to service and rate.

Attempts to Restrain Competition. Groups of railroads in different parts of the country at times became mindful of the ruinous nature of competition, and entered into agreements among themselves with the intent of restricting competitive activity. At times the subject of the agreements was rates, and the railroads would promise to maintain a given rate structure for a certain period of time. At other times, pooling agreements were entered into, and the railroads undertook to pool their traffic or the earnings from traffic, and to divide the business or the profits from it according to some prearranged ratio. While agreements of this sort were not punishable by law prior to 1887, they were nevertheless unenforceable at law, and there was every incentive for the railroads to attempt at times to evade the provisions of the agreements. As a result, most of these agreements did not enjoy long life.

Early Railroad Regulation. The disastrous effect of competition on the railroads, the complaints of shippers concerning local and personal discrimination, the fear of monopoly power under rate and traffic agreements, the speculation and fraud which pervaded railroad finance, and the attitude of railroad officials and executives toward the public, were some of the causes which influenced Congress to begin a long career of railroad regulation by passing, in 1887, the Act to Regulate Commerce. The legislation pertaining to the railroads has been constantly changing since that time, but it was only after almost thirty-five years of regulation that anything like a constructive approach to the railroad problem was adopted in our railroad legislation. It will be impossible in this chapter to analyze in any detail the provisions of the various Acts which have been passed in regulating the railroads, but it is essential to an understanding of the railroad problem of today that the chief defects of the early railroad legislation should be pointed out. The two principal defects were closely related to each other.

The Negative Character of Early Legislation. One defect of our regulatory scheme prior to the last twenty-five years was that it concerned itself chiefly with provisions intended to keep the railroads within bounds, and to prevent the exploitation of the public through unreasonable transportation charges and arbitrary malad-

justments in rate relationships. The principal aim of regulation was to wipe out railroad abuses, and consequently most of the provisions of the legislation took the form of prohibitions. For example, the railroads were warned that they must not discriminate between persons or companies, must not charge more for a short haul than a long haul unless granted specific permission, and must not enter into agreements for the pooling of traffic or earnings. From a positive point of view, not much was said as to what the rates should be. Our legislation did provide, of course, that rates should be "just and reasonable," but no significant meaning was given to these terms prior to the legislation passed in 1920. In short, the early railroad legislation treated in detail the things that the railroads should not do, but paid little or no attention to what they should do if the country was to have an efficient national transportation system. The items which were omitted from the regulation, rather than those which were included, seem to us to constitute the primary purpose of regulation.

The Policy of Enforced Competition. Though attempts were made, as was stated above, to eliminate some of the worst abuses which sprang up under competition, there was a continued insistence on competition as the condition under which the development of our railroad system should go on. "The anti-pooling clause of the Act to Regulate Commerce, and the prohibitions of the anti-trust laws as judicially applied to the railroads, created serious practical obstacles to the development of responsible relations between the carriers, to the elimination of personal preferences, to the stabilization of competitive conditions, to the achievement of such economies as coordination might render possible, and to the full and flexible utilization of the available plant and equipment. This condemnation of cooperative effort among the carriers through insistence upon the rigorous enforcement of competition, despite the subversive tendencies of such competition in the direction of rate fluctuations and discriminatory practices, and despite the difficulties of maintaining uniform charges among competitors of strikingly unequal strength, was but a reflection of the primary emphasis of the regulatory scheme upon restraining the potential overreaching of quasi-monopolistic power rather than upon the provision of a satisfactory system of transportation." [3]

[3] I. L. Sharfman, *The Interstate Commerce Commission*, New York, Commonwealth Fund, 1931, part I, pp. 79, 80.

The Railroads and the First World War. Because of the nature of our railroad legislation, its application brought results which were, in many respects, undesirable. We spent too much time seeing to it that railroad rates were not unreasonable or discriminatory, and gave too little attention to the question of efficient railroad transportation and to providing the railroads with a rate system which would permit them to earn a sufficient amount to enable them to attract into the industry the capital so necessary for continued efficient operation. Consequently, when the heavy traffic of World War I began to make unparalleled demands upon our railroads, they were unable to respond adequately. During this great national emergency, the wastefulness of competition in railroading and the importance of having an efficient national system of transportation were fully realized for the first time.

In order to avoid the complete breakdown of our system of railroad transportation which seemed imminent, the federal government undertook to operate the railroads during the participation of the United States in World War I and for some time afterward. It was impossible, of course, to revolutionize the railroad industry and transform it instantly from a disorganized and inadequate competitive system into an efficient national organization, but many steps were taken during the period of federal operation which augured well for the future. The railroads were operated "as a national system of transportation, the common and national needs being in all instances held paramount to any actual or supposed corporate advantage." [4] Locomotives and other rolling stock were pooled and used as necessity dictated, without regard to ownership. Shipments of freight were moved to their destinations by the most direct routes, regardless of the wishes of shippers as to routes or the amount of use made of any particular railroad in the process. Certain railroads were compelled to share their terminals with other railroads, and repair shops were used jointly. Cars were loaded heavily and the demurrage rates, or charges for leaving freight in the railroad cars in excess of a reasonable length of time, were increased to speed up car unloadings. Passenger service was cut down, and consolidated ticket offices were introduced. The purchase of materials and supplies was centralized, new equipment was standardized, expenses for advertising were reduced, and valuable uniform statistics were compiled.

[4] *Ibid.*, p. 155.

Whatever conclusion may be reached as to the financial or operating success of the federal control of the railroads, we may at least be thankful for the new attitude toward the railroads which prevailed after the war. When the question of the terms upon which the railroads should be turned back to their private owners was being considered, many different plans were evolved, and yet they all agreed more or less completely in one particular. This was that the growing transportation needs of the country demanded, through some method or other, the welding together of the many independent railroads, each formerly following its own self-interest, into an efficient national system of transportation. It appeared that only by some plan of consolidation or cooperation could economies in operation be achieved, and the railroad plant and equipment be efficiently utilized, while difficulties of rate regulation were being overcome.

The Transportation Act of 1920

The attitude toward the railroads described above received its first legislative expression in the Transportation Act of 1920. Under this legislation, the control of the railroads subject to the provisions of law was continued in the hands of the Interstate Commerce Commission, the agency set up for that purpose in 1887 by the Act to Regulate Commerce. The Interstate Commerce Commission is made up of eleven members, appointed for terms of seven years each by the President of the United States with the consent of the Senate. The work of the Commission is expedited by the provision that it may organize itself into as many divisions, of not fewer than three members each, as may be necessary to handle its business, and that each division may act independently of the others, with its decisions subject to reconsideration by the Commission as a whole. The Act of 1920 placed upon the Interstate Commerce Commission some new responsibilities which were expected to be of great import in connection with the solution of the railroad problem. We shall consider the provisions of the law and their operation under four headings—railroad consolidation, rates, securities, and service.

Railroad Consolidation. In the first place, the Act of 1920 was noteworthy in that the traditional emphasis on competition in the railroad industry was discontinued. The Interstate Commerce Commission was ordered to prepare and adopt a plan for the consolidation of the many railroads of the United States into a limited num-

ber of systems. In drawing up such a plan, the Commission was asked to bear two considerations in mind: (1) To preserve as far as possible the existing conditions and channels of trade, and (2) to make each system such a combination of weak and strong roads that, when uniform rates are applied throughout the country, each system will make substantially the same rate of return upon the value of its property devoted to the transportation service as that made by the other railroad systems. Under the consolidation plan (whenever formulated by the Commission), it was made lawful for two or more railroads to consolidate their properties for ownership, management, and operation, subject to two conditions: (1) The Commission must approve the proposed consolidation as being in line with its final consolidation plan, and (2) the par value of the bonds and stocks of the new consolidation must not exceed the value of the consolidated properties as determined by the Commission.

As a temporary expedient, pending the adoption of the final consolidation plan, it was provided that the Commission could permit one railroad to acquire control of another railroad or other railroads, by means of leases, stock purchases, or any method not involving actual consolidation. In addition, while agreements for the pooling of freight or net earnings were still held to be unlawful in and of themselves, it was provided as another temporary expedient that the Interstate Commerce Commission could approve such agreements and render them valid, or even go to the length of taking the initiative in bringing them about.

The Benefits of Consolidation. The benefits, from a social or national point of view, which might be expected to result from the consolidation of the railroads of the country into a limited number of systems as provided in the Act of 1920, are familiar ones. First, they would make it possible to realize important economies in operation and to utilize to the maximum the existing plant and equipment of the railroads, by methods similar to those employed by the federal government during its operation of the roads. These methods would include, of course, the pooling of locomotives and cars and their use anywhere in the system, the joint use of terminals and other facilities, heavy loading of cars, centralized purchases, standardized equipment, and uniform statistics. In the second place, the consolidation plan would replace numerous existing lines, of varying financial condition and command over traffic, with a small num-

ber of systems of approximately equal strength. As a result, rate regulation would be facilitated.

Rate Provisions of the Act of 1920. Congress, in drawing up the Transportation Act of 1920, was mindful of the necessity for adequate earnings in railroading and tried to make provision in the Act for rates which would make such earnings possible. The Commission was given the power to establish both maximum and minimum rates and, by fixing both, to decide upon the actual rates. Furthermore, it was made the duty of the Commission to exercise its rate-making powers in such a way that the railroads as a whole, or as a whole in such rate groups or territories as it might designate, would earn an aggregate annual net railway operating income equal, or as nearly equal as might be, to a fair return upon the aggregate value of the property of such railroads used in the transportation service. The valuation of the railroad property, and the determination of what constituted a "fair rate of return" upon such property, were to be in the hands of the Commission. In determining such fair rate of return, the Commission was to bear in mind the transportation needs of the country and the necessity of expanding railroad facilities, if adequate transportation was to be furnished. It will be noted that no provision whatsoever was made for individual railroads to earn a fair rate of return. It was only for the railroads as a whole, or in certain groups as designated by the Commission, that fair returns were to be sought. The word "group" in this connection may, we believe, be taken to mean a group of railroads somewhat larger than one of the limited number of systems into which the railroads of the country were to be consolidated.

The Recapture Clause. It was realized, of course, that rates high enough to give a fair rate of return for the railroads as a whole or in large groups would furnish some strong roads enjoying good location and excellent physical condition the chance to make an excessive rate of return. The "recapture clause" in the Act of 1920 was intended to provide against this contingency. According to the provisions of this clause, any railroad which received in any year a net railway operating income of more than 6 per cent on the value of its property devoted to transportation was required to share the excess above 6 per cent with the government. One-half of the excess income was to be turned over to the Commission for the purpose of setting up what was called a "general railroad contingent fund," while the other half was to be held in a reserve fund by the rail-

road. When the amount in this reserve fund equaled 5 per cent of the value of the railroad's property, the fund could be drawn upon, but only to meet fixed charges and make dividend payments in years when its net operating income fell short of the 6 per cent level prescribed by law. The general railroad contingent fund, on the other hand, was to be used by the Commission to make loans at 6 per cent interest to needy railroads, for the purpose of developing equipment or refunding maturing obligations, or to buy railroad equipment and lease it to the railroads.

Railroad Securities Under the Transportation Act of 1920. A third division of the Act of 1920 concerned itself with the control of railroad securities. The principal purpose of such control was to make sure that the financial operations of the railroads in the future would be of such a nature as to provide a sound basis for the rehabilitation of railroad credit and for the development of the railroad system. In addition, it was desired to protect the investing public against loss through extravagant and even dishonest financing, such as had taken place at times in the past. The principal provision of the Act, with respect to securities, was to make it unlawful for railroads to issue their own securities or to assume any obligations in connection with the securities of other railroads unless, after their application to the Commission and after investigation by the Commission of the purposes and uses of the proposed financial operation, the Commission should give its consent. The Commission was given rather wide discretionary power in deciding these financial matters, but it was asked to bear two considerations in mind: (1) The proposed transaction must be for some lawful purpose within the business of the railroad, and (2) it must be reasonably necessary and appropriate for this purpose.

Service Regulation. The fourth major problem touched upon by the Act of 1920 was that of adequate railroad service. Each railroad was ordered to furnish safe and adequate car service, and to set up and enforce reasonable rules and practices with regard to such service. Car service was taken to include the supply and use of rolling stock, the supply of trains, and interrailroad relationships with regard to rolling stock. The Commission was also empowered, when it considered such action desirable, to formulate reasonable rules and regulations to govern the railroad car service. In case of emergency, the Commission could abolish all existing regulations with regard to car service, and proceed (without regard to the desires

of any particular railroads) to provide for the unified utilization of railroad facilities, for the joint use of terminals, for preference or priority for certain commodities in transportation, and for direct routing and expeditious handling of traffic.

Finally, the approval of the Commission had to be obtained before an existing railroad enterprise, or any part of it, could be abandoned, or any new construction of railroads undertaken. Furthermore, in this connection, the Commission was again given power to take the initiative, and order a railroad to provide itself with safe and adequate facilities for carrying on its car service, or to extend its lines by means of new construction.

Progress Toward Consolidation. Though the Transportation Act of 1920 represented a refreshing and desirable change of attitude toward the railroad problem, it did not furnish a satisfactory basis for the operation of the railroads in the years after its passage. In the first place, comparatively little progress has been made toward the consolidation of the railroads. It is true, of course, that the Commission in 1921 published a tentative plan which provided for the consolidation of the railroads of the country into nineteen systems. One system was to provide for the needs of New England, five were to be trunk-line systems between New York and Chicago, and five were to be transcontinental systems from Chicago to the Pacific coast. The lower Michigan peninsula was to have one system, and there were to be two "soft coal" lines from the Chesapeake Bay to the Great Lakes. Finally, there were to be three systems in the Southeast and two in the Southwest. Extended hearings were conducted to consider the plan, but little has been done toward putting it into operation. However, several railroads have been allowed to carry out plans for consolidation with other roads or for the acquisition of control over them as provided in the law.

It must be remembered that consolidation cannot be forced upon the railroads by the Commission under the present law, and consolidation has not gone forward at a very rapid pace. In the first place, the strong railroads, those in good physical condition and with demonstrated earning power, have been unwilling to join forces with the weaker roads to form the type of systems called for by the Act of 1920, or at any rate to go into such consolidations except on terms rather unfavorable to the weak roads. And, in some cases, the railroad officials who would naturally carry on the negotiations for consolidation have not been anxious to do so for fear

they might be forced to accept positions in the new system which were inferior to the ones they already held.

The Control of Railroad Securities and Service. The provisions of the Transportation Act which related to railroad securities were not of great practical importance in the first two decades following 1920. Especially after 1929, railroad earnings were low and railroad credit did not rate so high as in former times. The carriers consequently experienced considerable difficulty in refunding their maturing obligations on satisfactory terms, and new issues, for many roads, were practically out of the question. The control of railroad service by the Commission was a source of irritation to railroad executives. They complained that the situation was one in which a company could not extend its facilities if business was profitable, or abandon production if business resulted in large net losses, without the approval of a governmental commission, and in which a company might be asked to share its facilities with competing companies.

Railroad Earnings Between 1920 and 1940. The most serious criticism of the Act of 1920 is that, in the first twenty years of its operation, railroad earnings were never entirely satisfactory and sank to a very low level after 1929. Apparently many people thought that the Act had disposed, for many years to come, of the problem of adequate railroad earnings; but a study of the net operating income of the railroads after 1920 discloses that this was decidedly not the case. The rates of net operating income of the line-haul railroads of the United States and their lessor subsidiaries, based upon the aggregate value of their property devoted to the transportation service, are shown in Table 25 for the years 1921 to 1944. These percentages are calculated on the basis of reported investment in railroad properties, plus materials and supplies and minus reserves for depreciation.

While it is difficult to say just what rate of return upon the aggregate value of railroad properties would be adequate, and no more than adequate, for the maintenance of an efficient transportation system, we may at least point out that the rates actually earned by the railroads between 1920 and 1940 were consistently below the rate determined upon by the Commission as one which it considered adequate and reasonable. The Commission decided in 1922 that, for the railroads as a whole, a rate of 5¾ per cent upon the aggregate value of the railroad properties used in the transportation

TABLE 25. THE RATE OF RETURN EARNED BY LINE-HAUL RAILROADS, AND THEIR LESSOR SUBSIDIARIES, UPON THE AGGREGATE VALUE OF THEIR PROPERTY DEVOTED TO THE TRANSPORTATION SERVICE, 1921–44 [a]

1921	3.04%	1933	2.03%
1922	3.89	1934	2.01
1923	4.72	1935	2.20
1924	4.64	1936	2.95
1925	5.15	1937	2.59
1926	5.45	1938	1.65
1927	4.68	1939	2.62
1928	5.07	1940	3.02
1929	5.31	1941	4.41
1930	3.62	1942	6.58
1931	2.21	1943	6.03
1932	1.37	1944	4.89

[a] Dr. D. P. Locklin, Professor of Economics, University of Illinois, kindly furnished us with these rates of return which he had computed.

service would be adequate; and it will be remembered that under the Act of 1920 the "recapture" of the earnings of individual railroads was to begin at 6 per cent. If the Commission's figure of 5¾ per cent is accepted as satisfactory for the railroads of the country as a whole, it is clear that the railroads, even in the period of relatively good business between 1921 and 1929, did not earn an adequate rate of return in any year.

Railroad Finances in the Great Depression. In the post-1929 depression, with its sharp decline in the volume of goods requiring transportation by any agency, the railroads were very hard hit. Their net earnings fell from 5.31 per cent in 1929 to the ridiculously low figure of 1.37 per cent in 1932. Between 1932 and 1940, the "peak" in railroad earnings occurred in 1936, when a rate of 2.95 per cent was achieved. The earnings rates we have presented are for net operating income *before the payment of interest charges on bonds.* After paying interest charges, the railroads had net deficits in 1932, 1933, 1934, and 1938, and very small net incomes in other years.

The number of passengers carried by the railroads, which had averaged 1,114,055,000 annually from 1916 to 1920, declined to 432,980,000 in 1933; and the revenue freight carried, which had averaged some 427,234,000,000 ton-miles from 1926 to 1930, fell to 233,977,000,000 ton-miles in 1932.[5] Railroads failed in large num-

[5] *Statistical Abstract of the United States, 1935,* pp. 368–375.

bers during the 1930's. At the end of 1940, 104 railroad companies with 75,765 miles of track were in receivership or trusteeship.[6] This mileage represented 31 per cent of the total for the United States. Even heavier casualties would probably have occurred had it not been for the activities of the Reconstruction Finance Corporation and Public Works Administration in lending $987,579,305 to the railroads during these troubled years. Of this sum, $376,386,271 had been repaid by the railroads by the end of 1940.[7]

The Causes of the Railroad Problem

The Problem of "Fair Valuation." While the desperate situation of the railroads in the 1930's was largely chargeable to the post-1929 depression, the rise of competing forms of transportation and defects in rate-making and rate regulation were also contributing factors. The Transportation Act of 1920 directed the Interstate Commerce Commission to use its rate-making powers in such a way that the railroads as a whole, or in groups designated by the Commission, would earn a fair return on a fair valuation of their properties devoted to the transportation service. This rule of rate-making sounds eminently fair, but it is difficult to apply. To begin with, what is a "fair valuation" of the properties of railroad companies? The use of the value of industrial properties as the basis for determining what earnings should be granted the owners exactly reverses the customary economic procedure. For the value of productive facilities ordinarily *depends upon the earnings* which the owners are able to make with their help. The *earnings* are capitalized at the current rate of interest, and this capitalization is the *value* of the productive facilities. Clearly, the valuation of the railroad properties for rate-making purposes had to be made on some other basis.

To many persons, the *cost* of the railroad properties seemed to suggest their value, but the application of the cost formula was also difficult. Should the value of a railroad's properties be the amount actually spent in acquiring them, or should it be what would have to be spent, at the time of valuation, for new properties with equal productive capacity? If original cost, and not reproduction cost, is decided upon, should the original cost include all expenditures actually made by the railroad, or merely an amount which it would

[6] J. H. Parmalee, *A Review of Railroad Operations in 1940,* Washington, Association of American Railroads, 1941, pp. 9, 10.
[7] *Ibid.,* p. 11.

have been "prudent" or "necessary" to spend? The principle of a fair return upon a fair valuation has lost much of its significance for railroading since 1933, and does not warrant a detailed examination at this point. It will be considered more fully in our treatment of public utilities in the following chapter.

The Problem of a "Fair Return." The Transportation Act of 1920 provided for the recapture of the earnings of individual railroads in excess of 6 per cent on the valuation of their properties, and the Interstate Commerce Commission decided that 5¾ per cent was a "fair rate of return." To make 5¾ per cent on the aggregate value of their properties over a period of years, the railroads would have to make higher earnings in some individual years, since they would certainly make less in others. It was possible, of course, for individual railroads to net more than 5¾ per cent in some years, by sharing with the government the earnings in excess of 6 per cent; but the rates which the railroads as a whole could charge for their services appeared to be adjusted in such a way that no more than the prescribed fair return would be earned by them as a whole in any year, while in some years the rate was certain to be less than that established by the Commission. This situation appears to be inconsistent with any satisfactory long-run interpretation of a fair rate of return.

Other Experiences with the Rule of Rate-Making. The rule of rate-making of the Transportation Act of 1920 was unfortunate in that it gave many people the idea that expert rate-making by the Commission would insulate the railroads against the effects of booms and depressions in general business, and afford the railroads a stable rate of return year by year. This hope has been shown to be entirely unrealizable by the events of recent years. The rule of rate-making apparently created, also, a disposition on the part of railroad executives to place complete responsibility on the Interstate Commerce Commission whenever the railroads failed to make a fair rate of return. Finally, the rule of rate-making has been shown to be a will-o'-the-wisp in a period of rapid technological change, such as that which has prevailed in the transportation field in recent years. Such technological changes usually require important readjustments in the industries affected, and may impose severe losses on established producers in the field. The investments which were made in the railroad industry may have appeared necessary and sound when they were made, but the rise of other forms of transpor-

tation may have rendered a part of the railroad facilities unnecessary and obsolete for purposes of peacetime transportation. Under such conditions, it may be impossible to set up any rate structure which will afford the railroads a fair rate of return on the entire actual investment which they made in their productive facilities, and it would seem logical to revalue the railroad properties so that the earnings which it is possible for the railroads to make will constitute a fair rate of return.

The Demand for Railroad Services. Some years ago, when the railroads provided the only satisfactory means of long-distance transportation, they could count on carrying most of the passenger and freight traffic of the country. In other words, the demand for their service was inelastic. Under this condition of demand, high rates for passengers and freight tended to yield better financial returns than low rates, and a rate increase could usually be depended upon to increase railroad earnings, if additional income was necessary.

But in recent years, motor vehicles and other carriers have developed into efficient and satisfactory agencies of transportation. Consequently, the country is no longer absolutely dependent upon the railroads and, for some types of traffic, can take the railroad service or leave it, depending upon the comparative rates and service of the railroads and other transportation agencies. Hence, the demand for railroad service is relatively elastic in peacetime. Under this condition of demand, high rates may prove financially disastrous to the railroads, while low rates may bring increased business and improved net earnings.

Some events of the 1930's suggested that many railroad executives had failed to recognize the changes that had taken place in transportation, and continued to think of the service provided by railroads as absolutely essential. When railroad traffic and earnings declined rapidly after 1929, the railroads in 1931, 1935, 1937, and 1938 petitioned the Interstate Commerce Commission for increases in freight rates. Some of the requests were granted and some rejected, but the increases in freight rates were not very helpful in the face of poor business conditions, the small total volume of traffic, and strong competition from other types of carriers. The conservatism of railroad officials also manifested itself in the slowness with which they adopted improvements in railroad equipment and service, and by their opposition in 1936 to the Commission's decision to reduce

railroad passenger fares in the hope of increasing traffic earnings.

The Railroad Labor Situation. Another factor operating to accentuate the railroad problem was the favorable treatment which the railroads have been required by law to afford the workers in the industry. The federal government, in carrying out its policy of railroad regulation, has not hesitated to raise the status of labor in the industry. In 1916, the average railroad employee worked 3151 hours for an income of $891.61, or 28.3 cents an hour. In 1940, the average employee worked a little over 2547 hours for an income of $1913, or 75.1 cents per hour. Hence, he worked 19 per cent less time in 1940 than in 1916, but received wages amounting to 114 per cent more. The total wage bill of the railroads was almost 34 per cent greater in 1940 than in 1916, and the total number of employees was about 38 per cent smaller.[8]

The railroads are compelled by law to maintain safety appliances for the protection of their workers, and the employees, of course, receive free transportation from the roads for which they work. They also receive various financial benefits under such laws as the Railroad Retirement Act and the Railroad Unemployment Insurance Act. Recent proposals for the benefit of railroad workers include the payment of the same wages for six hours' work a day as are now paid for eight hours, and dismissal compensation for employees affected by abandonments or unifications of railroads. While these advantages may not be greater than the railway employees should enjoy, they have unquestionably constituted a heavy burden upon the industry in times of depression. On this account, a general 10 per cent reduction in railway wages was permitted, and became effective February 1, 1932. However, the 1931 level of wages was completely restored by April 1, 1936.

Competition in Transportation. Probably the principal factor giving rise to the railroad problem was the loss of passenger and freight traffic to automobile and water carriers, both before and during the post-1929 depression. To be sure, the figures for 1939 show that the railroads were still carrying 62 per cent of all freight in the United States, as against 26 per cent for motor and water carriers combined. However, the railroads in 1939 handled less than 9 per cent of the passenger traffic, of which almost 91 per cent moved in busses or private automobiles.

[8] *Ibid.*, p. 33; and *A Yearbook of Railroad Information, 1940 Edition*, pp. 62–66.

After many years and much legislation of the trial and error variety, we eventually arrived at the significant conclusion that consolidation and cooperation of railroad lines are preferable to their competition as a means of obtaining efficiency and economy. However, we have been slow to realize that it is equally likely that coordination and cooperation of the several types of carriers—rail, water, motor, and air—would be better than competition, from the point of view of developing an adequate and efficient national system of transportation. Of course, not all of the railroad traffic losses were due to the competition of other types of carriers. Moreover, the railroads have no legitimate grievance in connection with the loss of traffic to other types of carriers, so long as the traffic gains of these carriers are based on superior service, more efficient operation, and lower costs. But the railroads have often charged that traffic has been taken from them by unfair competition. Into this question we must look a little further.

Water Competition. There can be no doubt that there is a place for water carriers in our transportation system, but the railroads have complained that much of the traffic handled by water carriers was secured on the basis of costs that were low only because of special advantages and favored treatment received by these carriers—treatment not accorded the railroads. In other words, it is contended that the competition furnished by some water carriers is essentially unfair to the railroads.

Certain inland waterways have been constructed at heavy cost to the federal government, and have proceeded to charge shippers rates so low that the receipts would barely cover the operating expenses of these water lines. When this sort of thing takes place, the shippers, of course, are not paying the full costs of transportation, but are being subsidized because the taxpayers assume the expenses for fixed charges and maintenance. The railroads, on the other hand, must maintain tracks, bridges, and terminals, and pay their own fixed charges and taxes. Thus, they not only lose traffic to these waterways, but pay heavy taxes as well, part of which go to the support of the waterways, their competitors. Incidentally, the taxes paid by Class I railroads in 1940 amounted to $396,000,000, or about 58 per cent of their net operating income of $682,000,000, before paying interest charges.[9]

To take an extreme example, let us consider the Mississippi-War-

[9] J. H. Parmalee, *A Review of Railroad Operations in 1940*, p. 26.

rior Rivers Barge Line. It has been estimated that the government spent 600 million dollars on this system and its branches. Since its construction as a war project, this barge line had carried, up to 1929, 7¾ million tons of freight at an average annual loss, borne by the taxpayers, of $440,000; and this figure is said to include no allowance for ordinary interest, taxes, and depreciation, such as a private transportation enterprise would have to meet.[10] More recently the Inland Waterways Corporation, operating federal barge lines on the Mississippi River and tributary waterways, reported that in 1939 it had carried 1,894,916 tons of freight at a net loss of $299,949, even though it paid no taxes or interest to private investors.[11] Not all water carriers, of course, can be compared directly with these lines; but it is probable that a considerable portion of the freight carried by water, amounting annually to many millions of tons, is carried at rates insufficient to cover total costs of production, if interest, maintenance expenses, and the taxes which would be collected from strictly private transportation agencies are included. This situation is clearly a cause for concern to the railroads.

Motor Competition. The competition of motor carriers was also serious during the 1930's. Not only did large numbers of people transport themselves from place to place by automobile, but common carriers by bus made quite a hole in the passenger traffic receipts of the railroads. In addition, large quantities of freight were being carried by truck, for both short and long distances. Some of the trucks operated as common carriers; that is, they ran over regular routes at specified times and served all comers. Others operated as contract carriers, furnishing each bit of transportation service on the basis of a separate agreement as to conditions of transportation, including rates, between the trucking company and the customers. Finally, many companies, engaged in other lines of business, did their own trucking.

The Advantages of Motor Carriers. Again, the railroads had no thought of contending that there is no place in our transportation system for carriers by motor, but they claimed that much of the competition furnished by these carriers was unfair to the railroads so long as motor carriers were unregulated as to rates and other

[10] E. E. Loomis, "Railroads vs. Waterways," in *Review of Reviews*, February, 1929, pp. 79–82.

[11] *Chicago Tribune*, May 28, 1940.

conditions of service, and enjoyed special advantages that were not available to the railroads in furnishing their transportation service. First, with regard to the alleged advantages enjoyed by motor carriers, it was pointed out that they are largely exempt from certain types of expense which the railroads have to bear. The roadbed for the motor carriers is the public highway, constructed and maintained at public expense, and the fixed charges on the investment in these highways are not paid by these carriers.

The motor carriers have shown that the heavy taxes which they pay are enough, or more than enough, to cover their share of the cost of constructing and maintaining the highways, but this is not quite the point. The motor carriers pay taxes, but these taxes represent their only contribution to the cost of constructing and maintaining their roadbed—the public highways. The railroads, on the other hand, claim that they have to construct and maintain their own roadbed, and in addition pay taxes which are at least as heavy as those paid by motor carriers. This claim must be discounted somewhat on the ground that rights-of-way, extra land, and in some cases money were given to the railroads by various governmental units many years ago.

In the second place, the railroads complained that the motor carriers were almost completely unregulated, since they were relatively free to charge any prices they liked for their services, whereas the railroads were not free to make changes in their rates to meet motor competition. Changes in railroad rates could be made, of course, but only slowly and with the consent of the Interstate Commerce Commission; and consequently the rates could not be made flexible enough to meet the rapid changes in rates open to the unregulated motor carriers. A truck owner could take a load a certain distance at a remunerative rate and, rather than return with an empty truck, could afford to pick up a return load at almost any price obtainable. With some exceptions, he could charge different people different rates for exactly the same service. He could charge more for a short than for a long haul, and was subject to almost no restrictions as to adequacy or regularity of service, being permitted to enter or quit the business at will. None of these advantages were enjoyed by the railroads. To have permitted competition between motor carriers and the railroads to continue on the terms described above, would have been to sanction a condition which was fraught

with danger for the railroad industry, and to make it extremely unlikely that the railroads, being closely regulated, could earn a return adequate to insure continuous, efficient transportation service.

Solving the Railroad Problem

The Federal Railroad Coordinator. As a result of the depression and other factors affecting the railroad problem, the railroad industry was in a woeful condition when the Roosevelt administration took office in March, 1933. This administration, however, lost no time in trying to assist the railroads. It was thought that part of the railroads' difficulty in obtaining adequate revenue was due to their failure to effect the economies which had been expected to accompany consolidation. As we have seen, consolidation had moved at a snail's pace since 1920, and the independent railroads did not cooperate in such a way as to reap any considerable part of the benefits which were expected to result from consolidation. Therefore, in 1933, a law was passed creating the office of Federal Coordinator of Railroads, which office was filled by Joseph B. Eastman, former member of the Interstate Commerce Commission. The duties of the Coordinator were (1) to encourage and promote, or require, the elimination of unnecessary duplication and waste, and (2) to recommend further legislation for the improvement of transportation conditions.

The office of Federal Railroad Coordinator was discontinued in 1936, but the Transportation Act of 1940 set up a Board of Investigation and Research for the transportation field as a whole. The Board had three members appointed by the President, and a statutory life of two years with a further extension of two years at the option of the President. The work of the Board fell into three general categories: (1) It was to study the extent to which public aid is given to rail, motor, and water carriers, and the taxes which are paid by these carriers to the various governmental units. (2) It was to examine the relative economy and fitness of these types of carriers, to determine the kinds of work for which each is especially suited and methods for developing the carriers into an adequate national system of transportation. (3) It had the power to investigate or consider any other matter relating to these transportation agencies which it thought might improve transportation conditions and effectuate the national transportation policy declared in the Interstate Commerce Act.

Rate-Making and the Recapture Clause. In 1933, the recapture provision of the Transportation Act of 1920 was repealed. This clause, it will be remembered, required individual railroads to turn over to the government one-half of their net operating income in excess of 6 per cent on the value of their properties devoted to transportation, and to place the remainder of such excess earnings in a reserve fund. The recapture clause had been a source of great annoyance to the railroads, though it probably was not a serious financial burden in view of the generally low railroad earnings since 1920. The clause seemed to be inconsistent with the declared principle of allowing the railroads to earn a fair return, in the long-run sense of that term, and we believe its repeal should be permanent.

The general rule of rate-making was also changed by the Transportation Act of 1933, and the emphasis is no longer placed simply on the "fair return on a fair valuation" as in the Act of 1920. The new principle provides: "In the exercise of its power to prescribe just and reasonable rates the Commission shall give due consideration, among other factors, to the effect of rates on the movement of traffic; to the need, in the public interest, of adequate and efficient railway transportation service at the lowest cost consistent with the furnishing of such service; and to the need of revenues sufficient to enable the carriers, under honest, economical, and efficient management, to provide such service." Though this new principle is somewhat less definite than the old one, it will probably furnish a more satisfactory general basis for rate regulation.

Passenger Rates. The Interstate Commerce Commission, through its control of both maximum and minimum railway rates, holds the power to decide what passenger and freight charges are to prevail. In 1936, the Commission decided to investigate the effects of reduced passenger rates. It ruled that the basic passenger fare should be changed from 3.6 cents to 2 cents a mile in coaches, and to 3 cents in Pullman cars; and also eliminated the 50 per cent surcharge on Pullman service. It was hoped that these reductions would bring an increase in passenger traffic which would more than offset the lower fares, and thus yield the roads a greater net income from passenger traffic. The results of this experiment cannot be stated very definitely. Railroad passenger traffic picked up sharply under the low rates, but before the full effects of the reduced charges could be thoroughly tested, the business recession of 1937–38 brought an upset to all calculations.

The reduced fares affected only the eastern railroads, since the roads in other parts of the country had already reduced their passenger fares. In July, 1938, the Interstate Commerce Commission permitted the eastern roads to raise the basic passenger fare from 2 to 2½ cents a mile, and these roads promptly made the change. The increased rate was experimental, however, and in February, 1940, the Commission denied a petition by most of the eastern roads for the continuance of the rate. Over strong opposition of the petitioning railroads, which threatened to carry the matter to the Supreme Court, the Commission ruled that the basic passenger coach rate must return to 2 cents a mile as of March 24, 1940.

Improvements in Railroading. In the late 1930's, the railroads manifested a highly progressive attitude toward their business. Some adopted streamlined trains for certain routes, and these trains both increased the speed and convenience of the service and lowered the operating costs. Most roads installed air-conditioned passenger cars, and made other changes which increased the comfort and convenience of railroad travel. Many inaugurated what is called a store-door pick-up and delivery service, to make the railroad freight service comparable to that furnished by motor carriers, and in some cases began to operate their own trucks and busses. In 1940, 66 leading railroads announced a new scheme to increase passenger business by selling railroad tickets on the installment plan. The plan operated through a separate company, called the Travelers' Credit Corporation, and applied only to trips costing $50 or more. Applications for credit were passed upon promptly, the customer obtained his ticket and took his trip, and payment was made in monthly installments. Such a wide-awake attitude on the part of the railroads was likely to be much more conducive to a solution of their problems than their former "standpat" attitude.

Financial Reorganizations. Some railroads found a partial solution to their problems by means of financial reorganization. The Transportation Act of 1920 did not give the Interstate Commerce Commission complete control over reorganization, but the Commission could pass on petitions submitted by railroads under the Bankruptcy Act of 1933. Over a period of several years, the Commission approved reorganization plans for 29 out of 43 petitioning railroads. These plans, when finally put into effect, would have reduced the total debt (including unpaid interest) of these railroads

from $4,056,426,489 to $1,749,573,800, and their obligatory fixed charges from $141,580,228 to $39,120,559.[12]

The Motor Carrier Act. A very important development in the transportation field was the passage, in 1935, of an act to regulate motor carriers. The Act did not actually become operative until several months of 1936 had elapsed. While this legislation was not intended primarily to protect other forms of transportation, but rather to improve and stabilize conditions in the motor carrier industry itself, the competition of motor carriers has affected the railroads so seriously in the past that we may well consider briefly the provisions of the Motor Carrier Act.

Provisions of the Act. The law applies to common carriers, contract carriers, and brokers engaged in interstate commerce by motor vehicles, but not to private carriers, except possibly with respect to safety regulations. The Act gives the Interstate Commerce Commission authority to prescribe rules governing employees, hours of service, and standards of equipment in the motor carrier industry. The numerous exceptions to the application of the law include school busses; taxis; hotel busses; motor vehicles operated by the Department of the Interior in the National Park service; motor vehicles used by farmers; motor vehicles of cooperative agricultural associations; trolley busses operated by electric power; motor vehicles carrying livestock, fish, and agricultural commodities exclusively; motor vehicles carrying newspapers exclusively; transportation within municipalities and adjacent areas; and casual, occasional, or reciprocal transportation by a person not engaged in transportation as a business.

Common carriers must secure certificates of public convenience and necessity, and must show the need for their service and their willingness and ability to perform it. Their business may include movements between fixed terminals and over regular routes, and only such business, but equipment and facilities may be added freely. Contract carriers must secure permits to operate, and must show the need for their service, their ability to perform it, the nature of the goods to be transported, and the territory to be served. They do not operate between fixed terminals, or over regular routes. Brokers, or persons other than carriers and their agents who sell

[12] *Fifty-Eighth Annual Report of the Interstate Commerce Commission,* p. 15.

transportation which is subject to the Act, must secure licenses, and show the need for their service and their ability to perform it. Common carriers already in operation on June 1, 1935, contract carriers in operation on July 1, and brokers in business on October 1, were allowed to secure certificates, permits, or licenses without further proof by making proper application before the last available date fixed by the Commission.

Common carriers must file rates and abide by them, subject to heavy fines for transporting without filing rates or for charging rates other than those on file. The rates must be reasonable and non-discriminatory, and may be changed only upon thirty days' notice to the Commission and the public. Contract carriers need file and publish only minimum rates. They may charge more than these rates, but changes in the minimum rates require thirty days' notice. The Commission does not have authority to prescribe the original rates for the motor carriers, but upon complaint or on its own initiative it may suspend and investigate any rates except the original ones. It may investigate the lawfulness of the rates on file and if, after holding hearings, it finds that rates do not comply with the law, it may prescribe new rates.

For purposes of enforcement, a divison of four members of the Commission was created to supervise all matters pertaining to motor vehicles. Under this division, a motor carrier bureau was established with district offices in various parts of the country. Violations of the law are subject to a $500 fine for a first offense, and $2000 fine for each additional offense. These penalties apply to both shippers and carriers. The common carriers must give bills of lading for goods transported, and the carrier which first handles a shipment is responsible to the shipper for any loss, damage, or injury caused by it or any other carrier, but the first carrier has a claim upon a subsequent carrier if the fault lies with the latter. The Commission controls security issues, consolidations, mergers, and acquisitions of control in the industry, and may recommend additional legislation. It is also authorized to investigate and report on the need for regulations as to the size and weight of motor vehicles.

At the very outset of the operation of the law there was considerable confusion. Motor carriers filed tariffs and then requested immediate changes. In some cases they failed to collect the published rates and fares, and did not make their tariffs available for public inspection. Sometimes the rates announced by carriers differed con-

siderably from those announced by their authorized agents, and the carriers complained grievously about one another. It was clear that there were considerable practical difficulties to be overcome in enforcing this law, because there were so many operators and because the business of many motor carriers was by no means so regular, well established, and easy to supervise as that of the railroads.

Motor Rates and Rail Rates. It has been common practice for motor carriers to disregard the traditional railroad principle of basing freight rates on what the traffic will bear. They have usually charged flat rates for transporting freight without regard to the value of the articles and the rate classes in which the railroads classified them, or have charged a flat rate at least for articles in the first three classes of the railroad freight classification. This practice developed from the high degree of competition in the motor carrier industry, which led operators to emphasize the *cost of service* rather than *value of service*. Its effect was the diversion of a considerable amount of freight traffic in articles of high value from the railroads to the motor carriers.

The railroads adopted a number of devices to meet this situation, the simplest of which was to lower freight rates on individual articles, reclassify such articles, or grant exceptions to classifications. Again, they developed "all-freight" or "all-commodity" rates for carrying freight, usually in carload lots, without regard for the classifications of individual articles that made up the shipments. These all-freight rates are commonly between 36 and 50 per cent of the rates on first-class freight. In some cases, flat railway rates on loaded trucks, trailers, semi-trailers, or "containers," when loaded with almost any kind of freight, have been authorized by the Interstate Commerce Commission.

The railroads have long charged lower rates for carload shipments than for less-than-carload lots of freight, but there have been no special rates for shipments involving several carloads or even a trainload, and no gradations between the carload and less-than-carload rates. Recently, however, the Interstate Commerce Commission has permitted some railroads to fix lower rates for multiple-carload shipments than for carload lots; and the railroads may thus be able to recover some of the freight traffic that has been moving by water in cargo lots. The railroads have also begun to establish graduated "volume rates" for large less-than-carload shipments. For example, the less-than-carload rate may apply to shipments up to

(say) 5000 pounds, a somewhat lower rate to shipments between 5000 and 10,000 pounds, a still lower rate for shipments from 10,000 to 20,000 pounds, and so on until the rate is reached for full carload lots.

While these changes in railway freight rates have been developing, the motor carriers have moved in the direction of the rate-making policies of the railroads. In many cases they now use railroad classifications of freight, or very similar classifications, and their freight rates are the same, or almost the same, as those of the railroads. However, common carriers by motor can scarcely afford to adopt railroad freight classifications and rates unless the contract carriers can be made to do the same, or unless the trucking operations of contract carriers and of industrial or other firms can be restricted. In general, the movement of motor carriers toward railroad freight classifications and rates seems undesirable, for its completion would deprive the public of the economies of motor transportation. Motor carrier rates should probably be allowed to rest on the competitive basis of cost of service, with business divided between the railroads, motor carriers, and other transportation agencies on the basis of convenience, efficiency, and cost.

Water Carrier Regulation. While the Motor Carrier Act brought another large section of the transportation field under the jurisdiction of the Interstate Commerce Commission, the Commission had only limited control over water carriers. That is, where joint rail and water routes were used, and in the cases where railroads were allowed to own water carriers, the Commission had jurisdiction. There was great need for the regulation of water carriers, comparable to that which had been applied to railroads and motor carriers. In the Transportation Act of 1940 that need was met. With the exception of contract water carriers which do not compete with common carriers, and common or contract water carriers of commodities in bulk whose cargo space is not used for more than three commodities at one time, the control of common and contract water carriers was placed in the hands of the Interstate Commerce Commission. The Commission may prescribe maximum, minimum, or specific rates; and it has control over the entry of firms into water carrier service, consolidations of firms, security issues, accounts, and other matters which it controls in the case of rail and motor carriers. The air transportation industry has also been thoroughly regulated since 1938, under the Civil Aeronautics Act and the Civil Aeronautics

Board, but this development was of less importance because of the very small volume of traffic that has moved by air up to the present time.

The National Transportation Policy. The Transportation Act of 1940 was also noteworthy for its statement of a national transportation policy. It said:

> It is hereby declared to be the national transportation policy of the Congress to provide for fair and impartial regulation of all modes of transportation subject to the provisions of this Act, so administered as to recognize and preserve the inherent advantages of each; to promote safe, adequate, economical, and efficient service, and foster sound economic conditions in transportation and among the several carriers; to encourage the establishment and maintenance of reasonable charges for transportation services, without unjust discriminations, undue preferences or advantages, or unfair or destructive competitive practices; to cooperate with the several States and the duly authorized officials thereof; and to encourage fair wages and equitable working conditions;—all to the end of developing, coordinating, and preserving a national transportation system by water, highway, and rail, as well as other means, adequate to meet the needs of the commerce of the United States, of the Postal Service, and of the national defense. All of the provisions of this Act shall be administered and enforced with a view to carrying out the above declaration of policy.

Certainly no one can quarrel with the general objective of fair and impartial regulation of all modes of transportation, but there may be some question as to what the objective involves. To many people, it would mean similar if not identical regulation of carriers by rail, motor, and water; but there are some reasons for believing that this approach is unsound. Carriers by water and motor are in general numerous and rather small, in comparison with the railroads. Their investments in plant and equipment and their fixed costs are smaller than those of the railroads, and the tendency to increasing returns is less pronounced. Motor and water carriers are not so likely, therefore, to engage in rate-cutting and cut-throat competition to attract additional traffic. It is somewhat easier for them, than for the railroads, to ascertain the cost of carrying goods, and their rates are more likely to be based upon cost of service than upon what the traffic will bear. Unlike the railroads, motor and water carriers do not often have a monopoly with respect to a large part of their traffic, and are unlikely to practice discrimination and to charge exorbitant rates. Finally, motor and water carriers can

more readily adjust their facilities to increases or decreases in the volume of current traffic.

These considerations suggest that the regulation of rail, motor, and water carriers in exactly the same ways and to exactly the same extent would fall short of the stated objective of fairness and impartiality in regulation. However, it does not follow that motor and water carriers should be unregulated. The failure to regulate them would be unfair to the railroads, and would neglect the interests of the country as a whole, since motor and water carriers serve the public, enjoy public assistance, and make use of public property. Moreover, it does not follow that motor and water carriers should not be controlled by the same commission which controls the railroads. Unification and centralization of regulation in a single commission may be desirable, even though there should be differences in the nature and extent of regulation as between types of transportation.

Transportation in Wartime

Railroad Traffic and Earnings. In spite of all that was done, the railroads experienced great difficulty in making ends meet, and their net operating income remained very low through 1940. However, World War II changed the picture. Gross national product increased from 88.6 billion dollars in 1939 to 187.4 billions in 1943, to 197.6 billions in 1944, and 197.3 billions in 1945; and there was a great increase in the quantity of commodities requiring transportation. Moreover, the 11,000,000 members of the armed forces had to be carried back and forth across the country, and large numbers of people who normally transported themselves by private automobiles in previous years were ruled off the highways as the result of gasoline rationing. At least temporarily, then, we needed all of our productive capacity in the railroad industry, and could have used even more.

The railroads were rather poorly equipped to handle the tremendous job of transportation which the war thrust upon them. The number of freight cars available was 22.8 per cent lower in 1941 than in 1929, the number of passenger cars other than Pullman was 28.8 per cent lower, and the average number of employees was 31.0 per cent lower. Nevertheless, with very modest increases in equipment and an increase of 23.9 per cent in the number of employees, "the railroads in 1944 performed 55.1 per cent more

freight service (ton-miles) than they did in 1941 and 225.3 per cent more passenger service (passenger miles). This remarkable increase in intensity of utilization of freight facilities is reflected in an average increase of 14.7 per cent in tons per car, a 48.6 per cent increase in ton-miles per car, a 24.4 per cent increase in tons per train, and a 57.6 per cent increase in ton-miles per mile of road. Passengers per car increased 113.3 per cent, and per train, 174.0 per cent; passenger miles per mile of road used in passenger service advanced 237.0 per cent."[13] The wartime accomplishments of the railroads were truly remarkable. As a result of the great volume of traffic, the net operating income of the railroads increased from $690,554,000 in 1940, to $1,499,364,000 in 1942, to $1,370,569,000 in 1943, and $1,113,153,000 in 1944.[14] The rate of return on the value of the railroads' properties increased from 3.02 per cent in 1940 to 6.58 per cent in 1942, 6.03 per cent in 1943, and 4.89 per cent in 1944.

Other Carriers. Motor carriers of property carried 34.5 per cent more tons of goods in 1942 than in 1940, and the corresponding percentages of increase for 1943 and 1944 were 49.3 and 49.6, respectively. The increase in average load per vehicle from 1941 to 1944 was 30.4 per cent for common carriers and 24.7 per cent for contract carriers.[15] The percentage increase over 1940 in intercity passengers carried by motor carriers of passengers was: 1942, 134; 1943, 244; and 1944, 262. There was an increase of 46.5 per cent in the loading per bus.[16] The amount of revenue freight carried by water carriers varied comparatively little during the war period, but the number of barrel-miles carried by oil pipe lines increased from 282 million in 1940 to 393 million in 1943 and to 438 million in 1944.[17] There were also considerable increases in the volume of air traffic over the war period, but the total traffic remained extremely small as compared with the total traffic of all types of carriers.

On the financial side, the net operating revenues of Class I motor carriers of passengers increased from $34,005,000 in 1941 to $147,-530,000 in 1943 and to $143,807,000 in 1944; but those of Class I motor carriers of property apparently declined over the war period,

[13] *Fifty-Ninth Annual Report of the Interstate Commerce Commission,* p. 2.
[14] *Ibid.,* p. 135.
[15] *Ibid.,* p. 3.
[16] *Ibid.,* p. 4.
[17] *Ibid.,* p. 146; and *Fifty-Seventh Annual Report of the Interstate Commerce Commission,* p. 163.

though the exact result is difficult to determine because of the change which took place in the number of carriers.[18] The revenues of water carriers showed no noteworthy trend during the war period, and the net income of pipe-line companies declined somewhat between 1940 and 1944.

Post-War Transportation Prospects

The General Outlook. The post-war prospects for transportation in the United States are difficult to determine. As the Interstate Commerce Commission has said:

> The situation abounds in uncertainties, not the least of which are as to the level of activity which business will maintain, the future of labor costs and taxes, and the effects of public expenditures on transportation facilities. Moreover, improvements in the instrumentalities of transportation mean new and heightened competition. The keynote of the post-war years will prove to be this quickening and extension of competition within and among the several forms of transportation and with private carriers. This competition has become identified in the public mind with the inroads which the commercial airlines are planning, and in part already are making, in the travel market, and in handling light freight. Competition between rail, motor-carrier, water, and pipe-line transportation, however, will undoubtedly increase in intensity. These various conditions emphasize the responsibility on us in seeing, so far as our powers permit, that the public interest is promoted and advanced along forward-looking lines and in the light of the national transportation policy declared by Congress in 1940.[19]

Prospects for Motor and Water Carriers. There are a number of favorable factors in the outlook for motor carriers of property and passengers in the post-war period. Wartime necessities brought them valuable experience with economical operating practices, some of which can be carried over into peacetime operation. Technological improvements in vehicles and fuel have been made, and will become available. Several states have liberalized their size and weight limits for motor carriers. Equipment notes and other obligations can be issued at relatively low interest rates. And better highway and street facilities will be available as a result of federal, state, and local expenditures. On the other side of the picture, the motor carriers need large numbers of new vehicles to replace worn-

[18] *Fifty-Ninth Annual Report of the Interstate Commerce Commission,* pp. 143–144; and *Fifty-Seventh Annual Report of the Interstate Commerce Commission,* pp. 162–163.

[19] *Fifty-Ninth Annual Report of the Interstate Commerce Commission,* p. 7.

out and obsolete equipment, and these vehicles will have to be purchased at high cost, although their operating efficiency may be superior. The motor carriers may have difficulty adjusting themselves to higher costs of labor and other things, in view of the fact that their rates are somewhat below those charged by the railroads. Finally, the motor carriers will have to face the loss of considerable volumes of wartime traffic to which they became accustomed and for which they acquired additional equipment in some cases, and will have a problem of restoring services which were suspended during the war.

Some water carriers ceased operating in their own right during the war, but most of these were able to secure substantial revenue by chartering their vessels or by operating as agents of the War Shipping Administration. Most water carriers came out of the war in sound financial condition. There were some gains in operating experience during the war, some obsolete and inefficient equipment was discarded, and marked technological improvements in vessels were made. On the other hand, the new ships will cost more per ton than those which they replace, and water carriers which ceased operating temporarily now face the problem of restoring physical operation, reestablishing contacts with shippers, and regaining traffic carried by other forms of transportation during the war.

Prospects for the Railroads. The outlook for the railroads in the post-war period is more favorable than it was for many years prior to the war. The railroads carried the vast volume of wartime traffic with only small increases in their investment in rail facilities. As a result they are not overbuilt to the extent which might have come about under other circumstances, and, when they need facilities in the post-war period, they can take full advantage of recent technological advances. The railroads are in generally sound physical condition. Deferred maintenance during the war is estimated at only $350,000,000, or 5.7 per cent of the total maintenance expense (excluding depreciation and amortization) in the years 1942–45.[20] Increased costs and high taxes reduced the railroads' net operating income in 1943 and 1944, as compared with 1942, but their financial condition is much better than before the war. Reduced debt and fixed charges, as a result of reorganizations and of ordinary refunding and refinancing, are also important in the financial picture.

[20] *Ibid.*, p. 8.

The railroads should be better off for their wartime trials and experiences. Knowledge acquired during the war concerning more efficient and economical operating practices may be carried over into peacetime operation, and even some advantages which resulted from close cooperation between the railroads and their customers in wartime may be perpetuated. Finally, the needs of wartime and the prospect of severe competition after the war tended to speed up improvements in railroad facilities. Many railroads have well-defined plans for discarding worn-out and obsolete equipment and for making major improvements in order to secure lower costs and give better service.

However, a number of factors are less favorable. There is a strong prospect for rising prices in the post-war period, and these are always of concern to the railroads, with their comparatively inflexible rates. Second, the labor situation is threatening. We have already spoken of the relatively favorable treatment of railroad labor which existed as of 1940. In 1941, after extended discussion, attempts to mediate, and threats of a strike, the railroad unions and management reached an agreement, about a month before Pearl Harbor, which called for an average increase of 12½ per cent in the wages of railroad workers. The railroad labor situation was rather quiet during the actual war period, especially after wage rates and salaries in general were frozen at existing levels late in 1942. However, the railroad labor unions sought higher wages almost as soon as the shooting war was over, and succeeded in getting increases in wages by arbitration late in 1945. In spite of this fact, the railroad unions demanded still higher wages and went on strike in the spring of 1946. It seems probable that in no other industry is labor in general treated so well as in railroading, and there is serious question how far the railroads can go in extending still more favorable treatment to their workers.

Third, the railroads are burdened with a very heavy tax load. Total taxes paid by them increased from $398,725,000 in 1940 to $1,854,136,000 in 1943 and to $1,849,909,000 in 1944.[21] This load could be carried successfully in wartime, but existing tax rates would cause great distress in the face of any considerable fall in traffic. Finally, the competition which other forms of transportation give the railroads would become keener if there should be a decrease in the total volume of traffic.

[21] *Ibid.*, p. 135.

In summary, it may be said that the post-war status of the railroads is closely tied up with the general level of production, employment, and income which is maintained in the economic system. There is little doubt that the railroads are overbuilt and have overcapacity with respect to the level of production and volume of traffic which existed during the 1930's. On the other hand, if production, employment, income, and the volume of traffic could be maintained at a high level in the post-war period, the railroads could probably get along very well, as could all the other transportation agencies. The general outlook for the railroads is sufficiently favorable to make us willing to adopt a "wait and see" attitude with regard to further proposals for solving the railroad problem. In other words, we think the time is not yet ripe to lend an ear to those individuals who contend that the railroads can no longer operate successfully under private management and who insist that we should proceed at once to bring them under direct governmental ownership and management.

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1. Why are the railroads important in our present economic system?
2. What is the nature of the "railroad problem"?
3. What is meant by saying that the railroad industry is one of increasing returns? How does the concept of increasing returns differ from that of decreasing costs?
4. Why are the railroads said to operate under conditions akin to those of joint costs?
5. Under what condition did the railroad industry operate during the early years of its life in this country? What abuses sprang up in connection with the railroads during this period? Why?
6. In what respects was the early legislation affecting the railroad industry defective? Explain fully.
7. What adjustments in railroad operation were made necessary by World War I? Why?
8. Why does consolidation in the railroad industry appear desirable?
9. What were the provisions of the Transportation Act of 1920 with regard to consolidation? What progress toward consolidation has been made under this law?
10. How did this Act undertake to control railroad service and the issuance of railroad securities?
11. What were the provisions of this law with respect to railroad rates and earnings? Explain.
12. How were railroad earnings affected by the Act of 1920?
13. How did the railroads fare in the depression years of 1929 to 1933?

14. Discuss the difficulties involved in applying the principle of a "fair rate of return on a fair valuation."
15. How was the "recapture clause" related to the problem of obtaining a fair rate of return for the railroads? Explain.
16. What change has apparently taken place in the nature of the demand for the services of the railroads? How has this change been related to the railroad problem?
17. "In general, the rule of rate-making provided by the Act of 1920 has proved unsatisfactory in practice." Discuss.
18. What was the significance of the railroad labor situation in connection with the railroad problem?
19. To what extent was the railroad problem due to the competition of other transportation agencies? Explain.
20. Why was the competition of motor and water carriers characterized as unfair by the railroads? Were the contentions of the railroads with regard to this competition sound? Explain.
21. What happened to the rule of rate-making and the recapture clause in recent legislation?
22. "The railroads are likely to make greater net earnings from passenger traffic with low fares than with high fares." Discuss.
23. What improvements did the railroads make in their equipment and operation during the late 1930's?
24. Summarize the main provisions of the Motor Carrier Act of 1935.
25. How did motor and railroad freight rates change in the last few years before World War II?
26. How were the regulatory powers of the Interstate Commerce Commission extended by the Transportation Act of 1940?
27. "If carriers by rail, motor, and water are to be treated fairly and impartially, they should all be regulated in the same way and to the same extent." Discuss.
28. What happened to the traffic and earnings of railroads and other transportation agencies during World War II?
29. What is the general outlook for transportation in the post-war period in the United States?
30. What are the post-war prospects for motor and water carriers?
31. "The railroads of this country entered the post-war period in relatively good condition." Explain.
32. What are the unfavorable factors in the post-war railroad situation?
33. Should the railroads be brought under governmental ownership and operation at once? Explain.

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22. Public Utilities

The railroads, which were discussed in the preceding chapter, are regarded as public utilities by some writers, while others, though admitting that railroads are "public utilities" in many essential respects, prefer to treat them separately. This separation makes for convenience in discussion, for the railroads have been regulated very largely by the federal government, whereas the control of public utilities has been carried on almost entirely by the state governments.

The Nature of Public Utilities

Natural Monopolies. It is not easy to draw up a complete list of public utilities, since the items included under this heading change from time to time. Among the activities which have been classed as public utilities at one time or another are street railways; water, gas, electric, telephone, and telegraph companies; steamship lines; grain elevators; and stockyards—in addition to the railroads. When used in conducting such activities, private property is no longer strictly *private*, because in such uses it becomes "affected with a public interest."

What is it that causes a business to be classed as a public utility? One thing is the possession of the characteristics which make it a "natural monopoly." A natural monopoly is a type of business in which competition usually results in duplication of equipment and great waste. Imagine, for example, the waste which would occur if a city were served by two competing street railway systems, with duplicate tracks throughout the town, and duplicate rolling stock, power lines, and operating personnel. Each of these companies might be confidently expected to have a higher cost of production per unit of service than the cost would be if a single transportation company were operating in this city.

Most public utility businesses require a huge original investment

in plant and equipment, and have large fixed or overhead costs. Such businesses enjoy increasing returns as they increase the volume of business transacted with a given amount of productive facilities, since the additional business increases only operating costs, and not fixed costs, while the total revenues expand considerably. Consequently a public utility company undertakes to get as much business as possible and, when two utilities offer the same service to the same customers, their relations often degenerate into cut-throat and destructive competition. Such a condition, marked by violent rate-cutting, is likely to last until one company is ruined or absorbed by the other, or until the competitors see the light and agree to combine. Even if competition were as economical as monopoly in these businesses, it might still be desirable to have some of them operated as monopolies. In telephone service, for example, it is important, in the interests of convenience, for all telephone users to be subscribers in a single company, rather than to have them distributed among several companies. As a result of these and other considerations, governmental units have come to recognize the need for monopoly in such businesses, and have permitted and even encouraged monopoly operation.

Essential Products. A second characteristic of public utilities is that their products, whether services or commodities, are generally regarded as vitally necessary to the public. In our large cities, thousands or hundreds of thousands of people look to surface, subway, and elevated railway lines for transportation, and their dependence upon other public utilities, such as electric companies, is so great that a stoppage of service, even for an hour or two, may lead to considerable inconvenience or even to genuine suffering. In the field of communication many individuals and businesses depend largely upon the telephone or telegraph service. In general, the demand for public utility services is inelastic. To be sure, the demand for (say) gas, on the part of some users at least, may be elastic because of the existence of satisfactory substitutes, but the demand for heat, light, or power in some form or other is relatively inelastic.

Franchises. A third characteristic of public utilities is that many of them are dependent, for the right or power to operate, upon privileges or favors granted them by the public through various governmental units. Street railways, and water, gas, and electric companies, must use public streets or highways, or the areas above

or below such streets and highways, in the conduct of their business, and are given grants, or "franchises," by state and local governments for this purpose. Moreover, governments sometimes grant public utilities the right to condemn private property for necessary purposes or to use public water power in their business.

Differential Rates. A fourth characteristic of public utilities is that a company, such as one supplying electric current, is usually permitted to sell its service to several classes of consumers for different purposes at different prices. It is quite impossible to determine the *exact* cost of supplying the service to any particular class of consumers and, as a result, the rates charged are likely to be arbitrary and to be based upon "what the traffic will bear."

The Regulation of Public Utilities

With public utility businesses operating as monopolies in their particular areas, producing essential economic goods for which the demand is relatively inelastic, and depending in many instances upon special privileges or favors granted by the state, it is clear that the unregulated operation of these businesses by private enterprisers might result in great evils, including extortionate rates for inferior service and unfair discrimination between different consumers or classes of consumers. The possibility of operation of an anti-social nature led to early regulation of public utilities—so early, indeed, that the problems connected with public utilities were almost completely local in character, and their regulation could scarcely have been assumed to fall within the constitutional powers of the federal government. As a result, the regulation of public utilities has been conducted largely by the states.

Public Utilities Commissions. This regulation has not ordinarily been undertaken directly by state governments. Rather, the regulatory powers have been delegated to commissions. Some of the better-equipped public utility commissions have powers similar to those exercised by the Interstate Commerce Commission in regulating the railroads. They often control rates and fares, extensions and abandonments of service, the issuance of securities, the prevention of undue discrimination between different customers and classes of customers, the quality of the service, the valuation of utility properties, and accounting methods. Of all these many items, the most difficult and important is, of course, the regulation of rates.

The Regulation of Rates. The states, and their public utilities commissions, were at first left quite free to regulate the rates charged by public utilities. The courts, including the United States Supreme Court, refused to interfere with what was so obviously an exercise of powers granted to state governments by the Constitution and would neither set aside prescribed rates nor themselves set up rates for the utilities. Eventually, however, the court attitude changed and the Supreme Court decided that if rates set by state governments or their commissions were so unreasonable as practically to destroy the value of the properties of public utilities, they could be set aside as violating the "due process" clause of the federal Constitution. Thereafter, the commissions, while trying to protect the interests of consumers, have been kept from setting public utility rates at so low a figure that they would be confiscatory with respect to the properties of public utilities; and the general idea has developed that rates should be regulated in such a way as to enable the utilities to earn a "fair rate of return on a fair valuation of their properties."

The Problem of Valuation. It is all very well to say that the utilities should be allowed to earn a fair rate of return on a fair valuation of their properties, but quite another matter to apply the principle to specific cases. The first difficulty is to establish a fair valuation. The property of a public utility scarcely has a value, in the usual economic sense of exchange value, since it is seldom bought and sold and is hedged about with restrictions and regulations which do not affect ordinary property. The value of a piece of industrial property is usually determined by the income it is capable of earning. But in the case of public utilities, earnings depend upon rates and these rates (if they are to represent a "fair return") cannot be set until after the "fair valuation" has been determined. Therefore, the commissions have had to turn to other methods of evaluating the properties of public utilities. The problem of valuation has usually been approached by way of "prudent investment cost" and "reproduction cost."

Prudent Investment Cost. Prudent investment cost is ordinarily taken to mean the amount of capital actually invested in a public utility enterprise, corrected for capital expenditures dishonestly made or made in a clearly wasteful or extravagant manner. There are several possible ways of arriving at prudent investment cost.

It is sometimes said that the par value of the stock of a public utility represents satisfactorily the amount of the actual investment in the business. This criterion, however, could not be applied to all public utilities, since some have issued stock with no par value. Moreover, there may be only a vague relationship between the par value of a utility's stock and the actual value of its property. Some public utilities are overcapitalized, and have outstanding an amount of stock well in excess of the value of their properties. For example, a public utility company, just starting in business and short of cash, may wish to acquire a piece of property without paying cash for it. To induce the owner to accept stock in lieu of cash, the company may have given him stock which has a par value well above the cash value of the property that is being acquired. Of course, to allow public utilities which are overcapitalized to earn a fair return on their capitalization would be to grant them an excessive return on the actual value of their property.

Again, the par value of a company's stock may at one time have represented accurately the value of its property, but may no longer do so because through poor management the utility has lost some of its original assets or had them depreciate in value. Or the property of a company may increase in value without the increase being reflected in the amount of capital stock outstanding. In either case, a fair rate of return on the basis of capitalization would give a return on the actual value of the property which was either larger or smaller than it should be. Consequently, capitalization has little to recommend it as a basis for valuation.

Another proposal is to assume that the market value of a public utility's stock represents the present value of its property. About all that can be said for this method is that a valuation could be readily obtained by finding the total value of the company's stock on the stock exchange. Such a valuation would be most unsatisfactory, however. The value of the company's stock depends largely upon the rate of return which prospective owners hope to obtain by holding it, and the total value of its stock tends to be its present and probable future rate of earnings, capitalized at the current rate of interest. Since the total value of the stock depends upon the company's earnings, to make the earnings dependent upon the total value of the stock would be to reason in a circle. If a company were at present making an excessive return upon its actual investment, its stock would tend to sell well above par. And if the present value

of its stock were taken as its valuation, a fair rate of return on this valuation would permit the continuance of an excessive rate of return upon the actual investment.

Original Cost. If we were to use prudent investment cost as a method of valuation, it would be necessary to find a satisfactory method of converting the term into action. This might be done, it is often said, by taking prudent investment cost to mean the actual original cost of a public utility's properties, adding the cost of additions and improvements, and deducting any depreciation in the properties or loss of assets. It is argued that such a valuation is eminently fair to all concerned. It grants a public utility a fair return on the capital actually invested in the business, as of the present time, and the utility has no right to claim better treatment. Moreover, it protects consumers from having to pay rates which would give the company a fair rate of return upon an excessive valuation of its properties. Finally, the valuation on the basis of original cost, once ascertained, would not change except when actual changes in investment occurred in the future, and it would provide a stable basis for rate regulation.

But there are some drawbacks to this method of valuation. One is the obvious difficulty of ascertaining original cost. Many public utility properties were acquired long years ago, and records of the transactions may have been lost or destroyed, if indeed they were ever kept. If a company originally acquired property by giving the owner stock instead of cash, should the original cost of the property be construed to be the par value of the stock given, or an estimate of its cash value at the time? Or if, at some time in its career, a company has bought out competitors, through either cash purchase or the exchange of securities, and, in order to be rid of the competitors, paid an excessive price for their properties, should original cost be interpreted to mean the price actually paid or only the construction value of the properties? Should an allowance be made the company for the original cost of promoting the company, of building up good will, and of acquiring a franchise and, if so, how large an allowance? How can we prevent companies from padding their costs, if original costs are used as the basis for valuation? These and other questions suggest that there is considerable room for error in estimating original cost.

Even if it should be possible to ascertain original cost accurately, there is no assurance that this method of valuation would be fair

to public utility companies and investors at all times, since it does not take into account changes in the general price level. The original cost method gives a fixed valuation to a public utility company's property, and a fair rate of return on this valuation means a relatively fixed money income. In a period of falling general prices, this stable money income would give increased purchasing power to the company and its stockholders, and impose a correspondingly heavy burden on the consumers, while in periods of rising prices it would bring decreased purchasing power for company and stockholders, and the consumers would be obtaining public utility services at bargain prices. This objection is not so serious as it sounds, however, for public utility commissions do not guarantee the utilities a stable money income. They merely try to regulate rates so that utilities will *normally* make a fair rate of return on the value of their property. Even if the rates are not reduced in a period of falling prices, the volume of business done at these rates will likely decline to such an extent that a utility's real income will not be enhanced unduly; and if rates are not raised in a period of rising prices, the increased volume of business at these rates may serve to keep the utility's real income from declining severely. However, the long-time upward or downward trends in general prices may serve to affect, either favorably or unfavorably, the purchasing power of the income received by public utility companies.

It is also said that the original cost method of valuation tends to discriminate between the consumers of the services of different utility companies. If one company's plant was constructed and its property acquired at a time when prices and costs were high, its consumers would have to pay rates sufficiently high to give the company a fair return on its high original cost. At the same time, the customers of another utility may be charged much lower rates because this company's plant was constructed and its property acquired at a time when prices and costs were low. Finally, the original cost method, when first introduced, may work a hardship upon persons who have bought the stock of public utility companies because of the high actual earnings of the companies and high returns paid on the stock. When the companies are subsequently limited to earning a fair return on the original cost of their properties, the dividends may be sharply reduced so that the stock will decline in value and deprive the owner of a part of his investment.

Reproduction Cost. The principal alternative to the use of prudent investment cost for valuation purposes is valuation on the basis

of the reproduction cost of public utility properties. In applying this method, the cost of reproducing or replacing a company's properties is estimated and this figure is adjusted for depreciation, or the supposed differences in value between the actual properties and similar new properties. Of course, if the properties are not allowed to depreciate, an adjustment is not necessary. Valuation on the basis of reproduction cost is a more recent development than valuation on the basis of original cost, and is more flexible and therefore more readily adjustable to changing business conditions. Moreover, it is said to be in stricter conformity with the dictates of economic theory. Since business enterprisers ordinarily plan future production on the basis of prospective prices and prospective costs, rather than upon the basis of costs incurred in past production, it is held to be more logical to evaluate public utility properties for rate-making purposes on the basis of reproduction cost, rather than original cost.

However, it is difficult to get a definite valuation by the method of reproduction cost, for several obstacles stand in the way. Should reproduction cost be taken to mean the cost of constructing identical productive facilities or substitute facilities which would have the same total productivity? Should it be estimated as under present conditions and methods of construction or under methods and conditions which existed when the company's productive facilities were constructed? What would it now cost to acquire the company's franchise or build up the good will which it developed in the past? These questions are more readily asked than answered, and in the absence of satisfactory answers the proper valuation of a company's properties on the basis of reproduction cost is a debatable matter.

The flexibility of valuation on the basis of reproduction cost may be an advantage or a disadvantage. When the general price level falls, the cost of reproduction falls also, so that a lower valuation for a property is appropriate, whereas the reverse is true in a period of rising prices. Assuming that the rate of return remains unchanged, the money income of the company will decline as the purchasing power of money increases and will increase as the purchasing power of money declines, so that the real income of the company and its stockholders should remain fairly constant. In general, a fluctuating money income and stable real income would be preferable to a stable money income and fluctuating real income. However, this adjustability means that the valuation of a company would

never remain stable for any great length of time, since it would change with changes in the general price level. As a result, a company's valuation would be constantly in a state of flux and neither the company nor the regulating commission would have anything definite to go on. The cost of reproduction method is advantageous in that it does not discriminate between the consumers of different utility companies, as does the original cost method; for two substantially similar plants would probably be given approximately the same valuations on the basis of reproduction cost, however different their original cost may have been because they were constructed at different times and under different cost conditions. Furthermore, the use of reproduction cost is likely to cause plants to be built efficiently and at low cost, since original cost will not affect valuation or earnings, while under the original cost method there is an incentive to make the original cost high for valuation purposes. However, on the whole, the weight of opinion favors the original cost interpretation of prudent investment cost as the basis for public utility valuation.

The Fair Rate of Return. In addition to deciding, upon some basis or other, the valuations to be placed upon the properties of public utility companies, public utility commissions have to decide upon a fair rate of return on these valuations. This, also, is a difficult matter. The commissions must protect the public against the monopoly powers of public utilities, but at the same time the companies must earn enough to cover costs of production, so that they may render efficient service, maintain their productive facilities, and attract new capital for purposes of expansions and improvements. Moreover, in addition to deciding the rate of return they would like the utilities to earn on the basis of their valuations, the commissions must determine the prices for services which are most likely to produce the desired rate of return for the utilities, keeping in mind the uncertainty of business conditions and possible variations in the cost of producing the services. A given set of prices will produce different rates of return for different companies with identical valuation if the managements of the companies differ in efficiency. While problems of valuation and fair rate of return have attracted more attention than the problem of arriving at prices which will bring in the fair rate of return on the fair valuation, this latter problem is a very trying one.

Public utility valuation and rate regulation are so complicated

that they are often dealt with in complete volumes, but enough has been said in the present chapter to enable the reader to appreciate their difficulty. Under the circumstances, it is not surprising that attempts by several agencies to determine the fair valuation and fair return for a public utility company have resulted in valuations which varied by hundreds of millions of dollars, and in proposed earnings in which the largest exceeded the smallest by 100 per cent.

Another Method of Rate Regulation. The difficulties of the fair-return-on-the-fair-valuation approach are so great that in some cases commissions have abandoned this method of regulating rates and adopted what might almost be called a rule-of-thumb method. In Massachusetts, for example, the commission is said to take into consideration principally the economic situation of the company. It considers whether the company is paying dividends on its stock, whether the stock is selling at or above par on the market, whether the company is providing adequate depreciation reserves and is accumulating a reasonable surplus, and whether its operating and maintenance expenses are being increased or decreased under current business conditions—and only then are they ready to hand down a decision in a rate case. The commission makes no attempt to give the public utilities a particular percentage rate of return on the value of their properties, but tries merely to control rates so that the companies may pay dividends high enough to keep the value of their stock above par and permit the companies to market additional securities, when necessary, at not less than par. This plan seems to have much to recommend it, but its standing, in the light of past utility decisions of the Supreme Court, is uncertain.

The Success of Public Utility Regulation. It was necessary for the state governments to delegate the regulation of public utilities to public utility commissions, for direct regulation by state legislatures would scarcely be feasible. But it must be admitted that commission regulation has not been entirely satisfactory. This may be accounted for in part by the fact that the commissions have been set to work solving problems for which there are no wholly satisfactory solutions. Some commissions have been given adequate powers and ample expert assistance, so that they have been able to operate successfully, but the reverse is true in many cases.

Many conditions among public utilities which the commissions were expected to remedy have continued to exist. They have often been unable to prevent utility companies from inflating or writing

up the value of their assets, or from selling securities amounting to much more than the aggregate value of their assets. Indeed, it is probable that total overcapitalization in the public utility industry runs into billions of dollars. While the commissions have usually discounted to some extent the claims of public utilities with respect to the value of their properties, it is nevertheless true that the official valuations of these properties have often greatly exceeded the amount of the actual investment. A fair rate of return on an excessive valuation is equivalent, of course, to an excessive rate of return on a fair valuation.

Even if the valuation were perfect and the rate of return fair, the common stockholders of a utility company might still receive an unduly high return on their investment, because of the low fixed rates of return to holders of bonds and preferred stock. When the valuation is excessive, and the fair rate of return represents a very high return on total actual investment, the earnings of common stockholders on their investment may run to four or five times the nominal fair rate of return. It is true, also, that commissions have been unable to prevent excessive discrimination between different classes of customers. Of course, no one contends that all customers should be charged the same rates for (say) electricity, regardless of the amount of power used or the hours at which they use it, but electric companies have been known to sell a large part of their power to other utility companies at less than cost, and to industrial users at but little above cost, while charging domestic or residential consumers from fifteen to twenty times the average cost of generating and transmitting the current.[1]

Weaknesses of the Commissions. While the regulatory problems faced by the commissions are very complicated, it is probable that much of the ineffectiveness of regulation has resulted from the inadequacy of the powers granted to some commissions and to defects in their personnel. The commissions control only electric light and power companies in two of the states. Gas companies are controlled by commissions in 40 states, water companies in 39 states, street railways in 40 states, and telephone and telegraph companies in 44 states. Only about two-thirds of the states have granted their commissions the authority to prescribe a uniform system of accounting for public utilities, and yet, without something of this sort,

[1] C. D. Thompson, *Confessions of the Power Trust*, New York, E. P. Dutton & Co., Inc., 1932, pp. 216–227.

it is almost impossible to determine the facts needed for valuation and rate-making purposes. In only one-half of the states do the commissions supervise the issuance of securities by utilities, and in fewer still do they exercise any real control over the uses made of the funds derived from the sale of securities.

Members of the commissions are elected by popular vote in 16 states, although it would seem that positions requiring so high a degree of technical knowledge might better be filled by appointment. The commissions themselves are made up of three members each in 36 states, and consequently are often too small for effective work. In a few cases the functions of commissions are not clearly defined in the state laws, and many commissions are handicapped by reason of insufficient funds. In 1929, for example, total state expenditures for the regulation of both public utilities and railroads amounted to only $7,200,000.[2] Despite these weaknesses, the commissions have done much by way of setting up standards of service and safety for the utilities, although, as was previously stated, they have not been especially successful with respect to valuation and rate-making.

Interstate Public Utility Activity. Two recent developments in the public utility field have conspired to make state regulation of the industry less effective than formerly. Many years ago, the business of the public utility was almost entirely local in character, but at present the services of a utility are often sold, at least in part, in other states than the one in which the company is located. Electric power is the public utility product which enters most largely into interstate commerce. This interstate business has created a curious "no man's land" of regulation. The Supreme Court has held that state commissions have no power to regulate rates or other matters in the case of electric power sold at wholesale by a company in one state to a company in another state for distribution in the latter. However, when a company in one state sells a public utility service directly to consumers in other states, the Court has ruled that such business may be regulated by the states unless and until the federal government itself attempts regulation. These interstate activities of public utility companies are pretty clearly a part of

[2] The statistics on public utility commissions are from C. M. Clay, *The Regulation of Public Utilities*, New York, Henry Holt & Company, Inc., 1932, pp. 144–149; and C. W. Thompson and W. R. Smith, *Public Utility Economics*, New York, McGraw-Hill Book Company, Inc., 1941, pp. 197–206.

interstate commerce and subject to federal control, but they are a complicating factor in state regulation.

The Development of Holding Companies. Another factor which has arisen to hamper state regulation of public utilities is the development of holding companies. Holding companies, as we shall see, may exert a tremendous influence for good or evil in the public utility field, but they are scarcely amenable to state control. They are connected with the public utility industry only through owning, directly or indirectly, a controlling interest in the stocks of actual public utility operating companies. Since they produce no utility services themselves, they do not come under the jurisdiction of public utility commissions; and since many of them operate in two or more states, they have not been readily controlled by the individual states. The problem of the holding companies has become so important that in 1935 the federal government made an attempt to control them and their activities. Before considering this attempt at federal control, we must look into the organization and practices of these companies.

Holding Companies

The Nature of Public Utility Holding Companies. Any company which holds the stock of other concerns may be called a holding company, but the term is usually reserved for companies that own a controlling interest in the stock of other companies and actively direct the affairs of these corporations. In the public utility field, a "first-degree" holding company is a corporation that owns a controlling interest in the stock of one or more operating utilities (those which really produce and sell electricity or some other service to the public) and that directs the business activities of the operating company or companies. A "second-degree" holding company will own a controlling interest in the stock of one or more "first-degree" holding companies, each with a group of operating companies under its control. Similarly, there may be holding companies of "third degree," "fourth degree," and so on. Holding companies, of course, are not limited to the public utility field. They exist in many of our major industries, but the problems which they present are probably of greatest significance in the field of public utilities, and it is primarily in this field that holding companies above the first degree are found.

The Financial Functions of Holding Companies. The champions of holding companies in the public utility field claim that many ad-

vantages result from the operation of these corporations. A principal function of holding companies is to furnish capital to operating companies. Public utilities require a heavy investment in fixed capital, and much new capital is needed from time to time for extensions and improvements. Public utilities in towns and small cities have often secured from local sources the funds with which to start in business, but they have often found it difficult to raise funds for extensions and improvements. They have been in a poor position to appeal to investment bankers for funds to be obtained through the issuance of securities, because they were small and unknown and lacked diversity of resources. In this connection, holding companies have been of assistance. They have accepted the securities of the small operating companies in exchange for needed funds, later recovering their outlay by marketing their own security issues, which were readily salable because the holding companies were comparatively large and well known and possessed resources (through the operating companies) which were well diversified in both character and location. Even when the security market has not seemed to be in condition to absorb new securities, the operating companies have often obtained funds from their holding companies, by direct loans. Through the operation of holding companies, the individual operating companies are able to secure capital on better terms than those on which they could secure it for themselves. It is claimed that such financial support has helped to improve the quality and reliability of service in small communities, and to replace small, inefficient plants with large, modern generating stations.

Other Holding Company Functions. Another benefit credited to the holding company is its ability to save money for its operating companies by acting as their purchasing agent. By purchasing at one time machinery, equipment, materials, and supplies for a number of operating companies, the holding company can buy in very large lots and obtain, in addition to lower prices, such advantages as better service, quicker delivery, and a prompter and more satisfactory adjustment of claims than the individual operating companies. Again, the holding company with a number of operating companies under its wing, can afford to have a department or a subsidiary company to provide the operating companies with expert construction and engineering service at a price lower than the operating companies would have to pay outside concerns. The holding company can also give its small operating companies the benefit of

high-class managerial ability and the experience which would otherwise be available only to the largest companies. Finally, it is often possible for holding company organizations to supply service to farms, and to small communities which could not themselves support public utilities.

It would seem that, if there were no offsetting disadvantages, the holding company would be the fairy godmother of the public utility industry, transforming, as by a wave of the wand, inefficient, high-cost operating companies into efficient, low-cost enterprises, and furnishing managerial and other services, materials, supplies, and capital to the operating companies on most reasonable terms. Without the holding company, it might be argued, many of our public utilities would be unable to operate, or could continue in business only by charging higher rates than at present. Why should anyone want to destroy or regulate so useful an organization? But there is, unfortunately, another side to the picture.

The Pyramiding of Holding Companies. If operating companies may enjoy these several benefits through the device of the holding company, it would seem that most of these advantages could be realized through the assistance rendered by a first-degree, or at most by a second-degree holding company. But our holding company systems have not stopped at the second degree. Many of them have had at the top a holding company which was several times removed from the operating companies in its fields. According to a well-known writer on financial organization:

> Out in Oregon, you find a little company called the Yawhill Electric Company. It belongs to the Portland General Electric Company. But the Portland Company belongs to the Pacific Northwest Public Service Company. This might be thought to be the parent organization. It controls the public utilities of Portland, the gas company in Seattle, and street railways and other utility companies in various towns. But this is not the end of the maze. The last-named company belongs to the Central Public *Service* Corporation, which owns other utility systems in Delaware, Maryland, and Virginia. And that in turn belongs to the Central Public *Utility* Corporation, which owns various other holding companies, with utilities and other sorts of enterprises from Maine to Oregon.
>
> But this is still not the end. The Central Public *Utility* Corporation is held by a super-holding company called the Central Public Service *Company*. Why the little Yawhill Electric Company in Oregon, the Tri-City Gas Company in Alabama, the Bridgewater Electric Company in Maine, and the Lower St. Lawrence Power Company in the Province of Quebec, plus a maze of companies (including the Compagnie d'Éclairage Élec-

trique in Haiti) in a dozen or more states, should all be huddled in this same holding company nest, no one can explain. And the interests which support these weird structures are powerful. Nothing short of action by the federal government, and plenary power in the agencies entrusted with the job, can clean up such situations.[3]

This should not be considered an exceptional case, for it is asserted that, in some public utility systems, the top holding company has been ten to fourteen stages removed from the actual operating companies. As to geographical distribution, it is well known that the Electric Bond and Share Company had operating companies in 36 states, and that each of eight other utility systems had operating units in from 11 to 29 states. While such complicated and widespread systems may not be justified from the point of view of the operating companies or the public, it is clear why the holding companies themselves desire to build up these complicated systems.

Power and Profits. The reason is this: As holding company is piled upon holding company, power and profits become increasingly concentrated in the hands of the few men who control the topmost holding company. The point may be illustrated by the following hypothetical example given by the Federal Trade Commission:

Suppose there are 100 local power companies, the aggregate total investment in which is $1,000,000,000, each owned and operated by a separate corporation. The total investment might have been raised by the sale in the aggregate of $200,000,000 of common stock, $200,000,000 of 7 per cent cumulative preferred stock, and $600,000,000 of 6 per cent bonds. If these companies are permitted by public authorities to earn 8 per cent on the total investment, or $80,000,000 annually, of this, $36,-000,000 would be required to pay the bond interest and $14,000,000 as dividends on the preferred stock. This leaves $30,000,000 for the common stockholders, either to draw as dividends or to use in further expansion of the business. This amounts to 15 per cent on the common stock investment and has been made possible out of the 8 per cent earned on the total investment only because the major portion of the total invested funds was furnished by two classes of investors whose per cent of return is limited.

Suppose, however, a particular group of promoters would like to make more than 15 per cent from these power company investments, and for this purpose forms a holding company with a total capital of $200,000,000 (the amount of the common voting stock of the operating companies), consisting of $100,000,000 of 6 per cent collateral trust bonds or 6 per cent debentures, $50,000,000 of 7 per cent cumulative preferred stock,

[3] J. T. Flynn and P. H. Gadsden, "The Holding Company Bill," *Forum and Century*, May, 1935, pp. 259–265.

and $50,000,000 of common stock. This group may be able to furnish the common stock money and persuade others to furnish the bond and preferred stock money, or, furnishing the common stock money, they may persuade the holders of the common stock of the local operating companies to exchange those stocks for this cash, together with the collateral trust bonds and preferred stocks. Now the $30,000,000 earned by the local operating companies on their common stock equities would accrue to the holding company. Out of it $6,000,000 would go as interest on the bonds and $3,500,000 would go as preferred dividends. This would leave $20,500,000 for the group of promoters who hold the common stock of the holding company, which amounts to 41 per cent on their investment of $50,000,000.

This group, however, might not be satisfied with this arrangement, or it might not have as much as $50,000,000 to invest. Suppose, therefore, that, instead of providing one holding company, it provides ten, dividing the local operating companies among them, the aggregate capital of the ten companies being the same as in the preceding case and of the same proportional structure in common stocks, preferred stocks, and bonds. Now suppose that the promoters organize a super-holding company with a total capital of $50,000,000 (the amount of the common stock of the ten subsidiary holding companies) consisting of $25,000,000 of 6 per cent bonds, $12,500,000 of 7 per cent cumulative preferred stock, and $12,500,000 of common stock. The promoters furnish the common stock money, thereby retaining for themselves the entire voting power in the whole pyramid of companies and constituting themselves the ultimate beneficiaries of the group's earning power, and sell the other securities to the investing public. The $20,500,000 of income left after paying interest and dividends on the bonds and preferred stocks of the operating companies and of the subsidiary holding companies accrues to this super-holding company. Out of it, $1,500,000 is required for interest on the super-holding company's bonds and $875,000 for dividends on its preferred stock. This leaves $18,125,000 for the common stockholders, or 145 per cent per year on the investment of $12,500,000 made by these promoters.[4]

This illustration shows that a small group of promoters, by investing $12,500,000, could gain control of $1,000,000,000 worth of operating companies, and receive their money back 1½ times each year—and the topmost holding company in this example is only of the second degree! By controlling more operating companies and carrying the holding company structure to greater heights, even better results could be obtained. Moreover, this illustration assumes that each successive holding company has acquired *all* the common stocks of lower companies, which would not be necessary for pur-

[4] Senate Document Number 213, 68th Congress, 2nd Session, pp. 173, 174, cited in C. D. Thompson, *Confessions of the Power Trust*, pp. 181–183.

poses of control. It also counts as profits of the topmost company only the income received indirectly from the operating companies' earnings. But holding companies also make profits from fees charged for various kinds of services performed for the operating companies. All in all, it is evident that the operations of holding companies may be very profitable to the "insiders."

The Duping of Investors. The above description suggests that, when the business is profitable, the small group of common stockholders of the topmost holding company is in a position to get most of the cream. And, when the business is unprofitable, most of the loss is borne by the holders of the other securities, since they have furnished most of the invested funds. In this connection, it should be noted that holding companies have sometimes been guilty of unloading very poor securities on investors. A first-degree holding company holds as its principal assets the common stock of the operating companies which it controls. It has, then, a claim, partial or complete, on the residual earnings of these companies. On the basis of this stock, however, the holding company often sells one or more issues of bonds and possibly three or four issues of preferred stock, while retaining control in the hands of a small number of persons through ownership of the common stock, or such part of it as has voting power. The holding company may pay exorbitant prices for the stock of operating companies and then proceed to sell an amount of its own securities which is far in excess of the real value of the securities which it owns.

While there may be justification for the issuance of bonds by a first-degree holding company, the fact remains that, as bonds are issued by holding companies further and further removed from the operating companies, these "bonds" become distinctly less secure than the common stock of many industries. The same is true, and to an even greater extent, of the preferred stock of high-degree holding companies. Take, for example, the case of a holding company of the fifth degree. Its assets consist largely of the stock of other holding companies. This stock represents a partial, residual claim, four times removed, on the residual earnings of the operating companies in the system. However attenuated this claim might seem to us to be, the fifth-degree holding company would often, upon the strength of this claim, issue securities which they called bonds, but which lacked almost wholly the certainty as to principal and interest which used to attach to securities bearing this name.

We see, then, that holding companies have sometimes issued securities, on the basis of fictitious asset values and paper profits resulting from stock dividends and other intercompany transactions, which did not truly represent the sums invested in underlying utility properties. These securities, issued merely on the hope of excessive income from subsidiaries, were likely to bring losses to investors. As one public utility company executive put it, "I know of no more reprehensible abuse than for speculators to buy up companies for high prices, put them into a holding company, and then, by trading on the credulity of the investing public relative to claimed increases in economy, to unload the holding company's securities at advanced prices and thus get completely out from under before the bubble is punctured, leaving the unfortunate final investor to face an angry consumer."[5]

Evils of Intercompany Relationships. Sometimes a holding company system has been so large that the top holding company, in addition to selling bonds and preferred stock, has had to sell part of its common stock to the public, leaving only enough in the hands of the insiders to enable them to control the system. In instances of this kind, the large profits left after paying bondholders and preferred stockholders, when business was good, had to be shared with these outside common stockholders. In such cases, but more particularly when the income arising from the subsidiary companies, though sufficient to pay bondholders and preferred stockholders, was not sufficient to pay large returns on common stock, those in control of the topmost company have sometimes found it desirable to tap the income of subsidiary companies at its source. This might be done in any of a number of ways.

Those in charge of the topmost holding company control the affairs of the subsidiary holding companies and the operating companies as well. They have the power to appoint, directly or indirectly, presidents and managers for the operating companies and determine their salaries. Often they have appointed themselves or their associates as officials of the subsidiary companies, at very choice salaries and occasionally with generous arrangements for pensions in their old age. Funds for these purposes came, of course, from the payments made by consumers for the services of the operating utility companies.

[5] Samuel Ferguson, President of the Hartford Electric Company, in the *Electrical World,* March 20, 1926.

Moreover, the men in control of the highest holding company often owned other companies which sold machinery, equipment, materials, and supplies, of the types required by the operating companies, or sold construction and engineering services. Hence, they were able to sell the operating companies commodities and services at virtually whatever prices they chose to charge. If, for example, the manager of a small electric company needed (say) a new dynamo for his plant, he would submit the matter to the manager of a holding company in another place. The holding company manager would tell him whether he could have the money for the operating company, how much he could have, just what he should buy with it, from whom he should make the purchase, and what price he should pay. This would often result in the equipment being purchased from a company owned by the men at the top, and at a price which they themselves fixed. If this company charged the local operating company too much for the equipment, nobody but the insiders would be any the wiser.

In these and other ways, those in control of a holding company system could often find ways to line their pockets without sharing the income of subsidiary companies with other people. The practice of charging exorbitant prices to operating companies for machinery and equipment was important not only from the point of view of "milking" the operating companies, but also because the rates the operating companies were allowed to charge were usually determined by public utility commissions on the basis of permitting these companies to earn a fair rate of return on the cost of the property of the companies used and useful in the public service. Hence, the rates paid by consumers might be unduly high because of the high prices paid by operating companies for equipment. Finally, it will be recollected that a major claim for the holding company is that it makes it possible for the operating companies to obtain capital which they themselves might not have been able to attract. However, this process has sometimes been reversed and the operating companies have been compelled, to their detriment, to make "upstream loans" to their holding companies.

Propaganda and the Control of Legislation. We must mention, also, as an evil related to holding companies, the extent to which these corporations have attempted to influence legislation in which they were interested. It was perhaps but natural that holding companies, in a country in which other large concerns or industries in-

dulge in such practices, would try to influence legislation through lobbying, bribery, and other methods. These methods, however, were quite as likely to be used against legislation designed to correct evils of the holding company as in favor of that proposed for the benefit of holding companies and operating companies alike. When the Holding Company Bill was before Congress in 1935, many holding companies spent large sums of money to defeat this measure. The funds were sometimes obtained through "contributions" made by the operating companies, or, again, came out of income received from operating companies in the regular course of business. In effect, then, the purchasers of utility services were paying to defeat a law intended, in part at least, to protect their interests as consumers. In addition to direct lobbying, the holding companies sought to induce security holders to write or telegraph their Senators and Congressmen urging the defeat of the bill. It was testified at a public hearing that public utility officials sent many identical telegrams denouncing this bill, signing them with names taken at random from telephone directories, and without the authorization of those whose names were used.

It has also been charged, and at least partly proved, that holding companies have conducted long and expensive campaigns of propaganda to influence public opinion in their favor. At times newspapers have been bought outright to insure favorable publicity for the industry. More often such publicity has been obtained through cordial relations established by heavy advertising in these newspapers. There is some evidence that college professors have been kept on public utility payrolls so that they might preach the gospel of the utilities; and the industry has also been successful in changing the content of some textbooks and inducing school authorities not to use others which contained unfavorable references to the industry. Utility companies have also been most generous in providing favorable materials about the industry for use in the schools.

The Question of Rates. Prominent utility officials have often contended that, whatever might be the evils of holding companies, the rates charged by operating companies to the consumers have not been adversely affected by holding company control. Since the operating companies are only allowed to charge rates which will produce a fair return upon a fair valuation of their properties, it is said to matter little to the consumers how thoroughly watered the securities of holding companies may be, or what happens to the

income of operating companies once it is received. Indeed, these officials have contended that the progressive reductions which have taken place in public utility rates indicate the benefits to consumers of utility operation under the holding company system. There may be question as to how general these reductions have been, but there is no doubt that they have occurred in some cases. However, those which have occurred in the past few years must be discounted to a considerable extent as having possibly been produced by the threat of regulation, rather than by lowered costs.

In any case, the lowering of absolute rates means comparatively little. That is, the low rates charged today may be further above the cost of production than were the higher rates charged in previous periods. The dealings of holding companies with their operating companies have been secret, and we have had no way of knowing whether the price paid for (say) electricity in a given community was, on the basis of costs or by comparison with the rates charged elsewhere by other operating companies under the same holding company control, a fair price.

We have now reviewed briefly the principal merits attributed to public utility holding companies, as well as the principal evils with which they are charged, and are in a position to examine and appraise the public utility legislation of 1935. At this point it is only fair to say that the evils pointed out have by no means been characteristic of all public utility holding companies. Some, indeed, have enviable records for fair dealing with both their subsidiaries and the public, but others have been guilty of most, if not all, of the malodorous practices that we have described.

The Wheeler-Rayburn Public Utilities Act

The holding company situation in the public utility field was so serious, and the powers of the state governments to control these companies were so feeble, that in 1935 the federal government undertook to provide regulation through the Wheeler-Rayburn Public Utilities Act. This Act was in two parts: Title One or the Public Utility Holding Company Act, and Title Two or the Federal Power Act. In Title One, a holding company was defined as any company which has, directly or indirectly, 10 per cent or more of the voting control of a public utility company or another holding company. Holding companies were brought under the jurisdiction of the Securities and Exchange Commission, the provision being that every

holding company which, on October 1, 1935, had outstanding securities offered since 1925 and owned to some extent in other states, must register with the Commission in order to remain in business. The Commission was empowered to exempt certain companies from registration under conditions too detailed to be described here. To secure registration, holding companies must produce full and complete information about their capital, resources, officers, and business. Periodic and special reports must be filed with the Commission.

Financial Matters. Several provisions of the Act are designed to correct specific evils that have marked the development and operation of holding companies. A uniform accounting system is prescribed for registered holding companies, and it is unlawful for any registered holding company or subsidiary company to acquire securities or capital assets of other companies without the approval of the S.E.C. The issuance of new securities by holding companies also comes under the jurisdiction of the Commission. Security issues must be well adapted to the financial structure of the issuing company and to its earning power; the financing must be necessary and appropriate to the economical and efficient operation of the business; fees and commissions in connection with the security issues must be reasonable; in cases of guaranty or assumption, the risk must not be improper; and the terms of sale must not be detrimental to the interests of the public, investors, or consumers. The purposes of security issues must be approved by the S.E.C. No-par stock, preference stocks, and debentures may no longer be issued.

Holding companies and subsidiaries may not declare or pay dividends in violation of such rules as the S.E.C. may prescribe to protect the financial integrity of the system, safeguard working capital, or prevent payments out of capital or unearned surplus. The acquisition or redemption, by a holding company, of its own securities, the sale of its own securities or other utility assets, and the solicitation of proxies, powers of attorney, and the like, are prohibited except under rules set up by the S.E.G. Holding companies are forbidden to sell securities from door to door, and to require subsidiaries to sell holding company securities. "Upstream loans," from operating companies to holding companies, are prohibited and other loans are regulated.

Contributions of holding companies or subsidiaries to any political party or candidate are strictly prohibited. Utility lobbyists must register with the S.E.C., and disclose the subject matter on which

they work, the fees they receive, and other specified information. Officers and directors of holding companies must file statements listing the securities of the holding companies and subsidiaries owned by them, and must make monthly reports of any changes in ownership. To prevent the misuse of inside information, profits realized by officers and directors from buying and selling such securities within any six-month period shall inure to, and be recoverable by, the companies, regardless of the intent of the officers and directors.

Other Intercompany Relations. Holding companies are no longer permitted to sell to operating companies directly, or through a subsidiary company, the various types of commodities and services which we have mentioned, at whatever prices they choose to set. On April 1, 1936, it became illegal for a registered holding company to enter into or perform any service, sales, or construction contract for an associated public utility company or mutual service company. A subsidiary of a registered holding company or a mutual service company may do these things only in accordance with the rules, regulations, and orders of the S.E.C., to insure that the contracts are performed at cost and that the burden of cost is fairly divided among the associated companies. Again, on August 26, 1936, it became illegal for a registered holding company or subsidiary to have, as an officer or director, any officer, partner, or representative of a bank, trust company, investment banking house, banking association, or firm, or of any corporation a majority of whose voting stock was owned by any bank, trust company, investment banker, banking association, or firm, except as the S.E.C. might permit.

The Act attempts to confine the activities of holding companies to the operation of gas and electric utilities and the holding of securities of such utilities. It is intended to prevent the indiscriminate combination of domestic and foreign utilities, and to prevent the use of the holding company to deny to the public the widespread and economical use of both natural gas and electrical energy, which are sometimes withheld merely because it is to the selfish advantage of a company to encourage the use of one of its products rather than another and deprive the public of the benefits of competition between the two.

The "Death Sentence" Clause. The most famous provision of the Holding Company Act was the one containing the so-called "death sentence" for public utility holding companies. This clause directed

the S.E.C., after January 1, 1938, to require by order that existing utility holding company systems be limited to one such company, and one subsidiary holding company, and to prevent control by the two companies over more than one integrated system of operating companies. Thus, the "death sentence" applies to holding companies above the second degree. According to the Act, an integrated system of operating companies is a system of one or more units of generating plants, and/or transmission lines and/or distributing facilities, whose utility assets, whether owned by one or more companies, are physically interconnected or capable of physical interconnection, and which under normal conditions may be economically operated as a single interconnected and coordinated system, confined in its operation to a single area or region, in one or more states, and not so large as to impair (considering the state of the arts and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation.

No exceptions are permitted as to the degree of the holding companies, but exceptions may be allowed in the number of operating systems to be controlled by the two holding companies in a system. Thus, more than one integrated operating system may be controlled whenever the Commission finds that such additional systems are incapable of economic independent operation, or operation without the loss of substantial economies not otherwise obtainable, when the additional systems are located in the same state or adjoining states, and when the continued combination of the operating systems is not so large as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation. The burden of proof in each case is on the holding company.

The Welfare of Operating Companies and Consumers. In general, the regulatory provisions of the Act were directed at specific and well-known evils. The powers given the S.E.C. differed little from those already exercised by some public utility commissions. The Act has met with fairly general approval, though public utility officials feel that some of its provisions are too severe and delegate too sweeping powers to the S.E.C.

However, the "death sentence" clause was attacked from several angles, one of which related to the welfare of the operating companies and of the consumers. It was said that the destruction of the holding companies would ruin the industry because the operating companies were dependent upon the holding companies for expert managerial services, supplies, equipment, and capital. With the

holding companies gone, the operating companies would have to depend upon their own resources and would be unable to operate with their customary efficiency. The result would be higher rates for consumers, or perhaps even the outright failure of operating companies and a growing need for government ownership. Indeed, it was sometimes charged that the aim of the Act was eventually to bring all public utilities under government ownership.

Supporters of the Act do not deny that many operating companies are dependent upon holding companies for capital, services, and commodities, and that the efficiency of these operating companies would be impaired if all holding companies were eliminated. They point out, however, that not all holding companies are to be dissolved, but only those above the second degree. It is probable that operating companies already derive a major part of their benefits from holding companies of the first or second degree. Even if this is not true now, there is no reason why first- and second-degree holding companies should not be able, after a reasonable period of time, to furnish all essential capital, commodities, and services to the operating companies. If this development takes place, holding companies above the second degree will perform no useful economic function, and their dissolution will not involve loss to the operating companies and consumers. According to William O. Douglas, former Chairman of the S.E.C.: "To the extent that the holding company can justify its dominion in terms of service to the operating companies, the statute is not a 'death sentence.' On the contrary, it holds the promise of a long life and a happy one." [6]

Even though the holding companies of high degree may not be missed, it might be uneconomical to deprive a first- or second-degree holding company of all but one of its integrated systems of operating companies. But, as we have seen, a holding company may be permitted to continue its control over more than one system of operating companies, whenever such control is in the public interest. In other cases, holding companies must be reorganized, or new holding companies organized, so that only one system of operating companies will be controlled by each. Given a reasonable period of time, it should be possible to accomplish the necessary reorganization with a minimum of loss to those involved.

The Destruction of Investments. There are many who contend that, while the dissolution of high-degree holding companies may be good riddance from the point of view of operating efficiency and

[6] *Electrical World,* May 14, 1938, p. 1604.

consumer rates, their loss will be mourned by people who have invested in their securities. It is argued that the government, by forcing the liquidation of these companies, will destroy the investments of their preferred and common stockholders, though the bondholders may get their money back. Let us suppose that a third-degree holding company is forced to liquidate. This means disposing of its holdings of securities of other companies, and selling its other assets. Out of the proceeds realized from the sale of its assets, the company will first have to pay the bondholders in full and there may be little or nothing left for the stockholders.

Supporters of the Act admit that the investors in certain holding company securities are deserving of sympathy. Undoubtedly, some of these "investments" have lost their value completely, or almost completely. They contend, however, that the government is in no sense responsible for these losses to security holders. Rather, the responsibility rests with the holding company executives, who sold worthless or questionable securities at high prices in the gala days of 1929 and earlier. The solicitude of these executives for the security holders is touching, but untimely.

It seems apparent that many high-degree holding company securities had lost most if not all of their value before the Act was passed or was in any danger of passing. For example, shares of American Gas and Electric sold in 1929 for as much as $225 per share and fell to $18⅞, and shares in Associated Gas and Electric, which had brought $46, were later offered at 39 cents each. Of course, as utility executives claim, not all holding companies should be blamed for the misdeeds of the guilty, but in 1929 the control of about 40 per cent of the power industry was concentrated in the hands of three large groups—the Insull group, United Corporation, and Electric Bond and Share. The stock of these companies sold in 1929 for as much as $79, $75, and $189, respectively, and during the depression went as low as 0, $1½, and $3⅝ per share, respectively.

Since the shares of many holding companies had dropped, before holding company legislation became at all imminent, to a figure which was only one to five per cent of their former values, the supporters of the law suggest that something more than the prospect of adverse legislation depressed their values. They also suggest that the holding company officials, who now weep over the fate of the utility investor at the hands of a cruel government, may be shedding crocodile tears. The man who bought the stock of a high-degree

holding company at \$75 a share, and watched it fall to \$1⅛ under a governmental policy of "hands off," is not likely to be impressed by the charge that the government, through the operation of the Public Utilities Act, is destroying the value of his shares.

Let us see how the Act is likely to affect the owners of securities. If we are correct in assuming that, after a period of reorganization, all holding company functions contributing to the efficiency of operating companies can be performed by first- and second-degree holding companies, those who hold the securities of the operating companies should not suffer through the operation of the Utilities Act. Similarly, the holders of the securities of first- and second-degree holding companies should not be affected adversely, since those which are sound and perform a useful economic function will not be dissolved.

We may agree that the holders of stock in high-degree holding companies are in an unfortunate position, while denying vigorously that this situation is attributable to the Utilities Act. Rather, the losses that the stockholders suffer will have resulted chiefly from the fact that they were inveigled into paying very high prices for stock which was essentially and inherently unsound. In other words, they were sold securities whose total price was far in excess of the value then existing or probable future value of the assets of the high-degree holding companies whose stock they bought. The Utilities Act must indeed be embarrassing to the gentlemen who foisted these securities on the public, but such embarrassment scarcely constitutes a valid criticism of the Act.

Enforcement of the Public Utilities Act. The constitutionality of the Act has been strongly challenged in the courts. When the time came for holding companies to register with the S.E.C., many refused to do so until the constitutionality of the Act had been determined. In February, 1938, it was estimated that holding companies controlling 56 per cent of the assets of utility companies subject to federal regulation had failed to register.[7] In March, 1938, the Supreme Court ruled that the registration provisions of the Act were constitutional. The Court held that the holding company involved in the suit in question was clearly, though to some extent indirectly, engaged in interstate commerce, and that, equally clearly, the registration provisions of the Act came within the power of Congress to regulate interstate commerce.

[7] *Chicago Tribune,* February 25, 1938.

Following this decision, several important holding companies hastened to register, but the constitutionality of the "death sentence" feature of the Act remained in doubt. This part of the Act was to be enforced as soon as possible after January 1, 1938, but the S.E.C. delayed its enforcement because of the uncertain status of the Act. In August, 1938, the S.E.C. set December 1, 1938, as the final date for the submission of reorganization proposals by all companies under the "death sentence" clause. On that date, the Commission announced that public utility holding companies representing "substantially 100 per cent" of the assets of the industry had furnished it with plans for simplifying their corporate structures, as required by the Act.

By June 30, 1945, considerable progress had been made in carrying out the "death sentence" clause. A total of 146 plans for simplifying the corporate structures of public utility holding companies had been filed with the Commission. Of these, the Commission had approved 56, frequently after securing necessary modifications; 23 had been withdrawn or dismissed; 3 had been denied; and 64 were pending in various stages of completion.[8] Public utility holding companies had already divested themselves of 342 electric, gas, and other companies with total assets of $4,347,000,000; and integration orders outstanding required the divestment of holding companies' non-retainable interests in 147 subsidiary companies having aggregate assets of $4,352,000,000.[9] The Commission had issued 46 orders involving simplification of corporate structures and equitable redistribution of voting power, and there were 47 such proceedings pending.[10] Altogether there were 63 cases pending as of June 30, 1945, involving 33 holding company systems, 92 holding companies, 768 operating companies, and aggregate assets of $13,601,872,095.[11]

Finally, the United States Supreme Court reached a decision on April 1, 1946, which declared the "death sentence" clause to be constitutional. The decision was written in a case involving the North American Company, which was the top holding company in a system containing 80 operating companies in seventeen states and the District of Columbia, and which had been ordered to confine its operations to a single integrated system built around the Union Electric Company of Missouri. The North American Company had

[8] *Eleventh Annual Report of the Securities and Exchange Commission*, Philadelphia, 1946, p. 36.
[9] *Ibid.*, pp. 35, 37.
[10] *Ibid.*, p. 35.
[11] *Ibid.*, p. 36.

contended that the ownership of securities is not in itself interstate commerce and hence could not be made the basis of federal legislation. The Supreme Court replied that Congress could protect the freedom of interstate commerce by any means that were appropriate, lawful, and not prohibited by the Constitution, and that previous decisions of the Court had recognized that Congress could deal with and affect the ownership of securities in order to insure the freedom of commerce. The North American Company had also contended that the "death sentence" clause was unconstitutional, as applied to the company, since none of the evils that led Congress to enact the statute was actually present in the affairs of this company. However, the Supreme Court replied that, if evils had disclosed themselves which entitled Congress to act as it did, the Congress had power to legislate generally, unlimited by proof of the existence of the evils in each particular situation. With the matter of constitutionality out of the way, the enforcement of the "death sentence" clause will probably be completed with dispatch.

The Federal Power Commission. Title Two of the Public Utilities Act of 1935 gave important powers to the Federal Power Commission. This body had been created in 1920 by the Federal Water Power Act. In the first fifteen years of its life, its activities were limited to licensing water-power projects for electrical development, regulating the accounting of such projects to prevent overcapitalization, and making power and electric rate surveys. The Act of 1935 gave the Commission regulatory powers over all facilities used for the transmission and sale of electric energy in interstate commerce, and over the sale of electric energy at wholesale in interstate commerce. The Commission is directed to divide the country into regional power districts, and to encourage interconnection and coordination of facilities within each district and between districts. Upon application of any state commission or person engaged in the transmission of electric energy, the Commission may direct a public utility (if it finds that no undue burden is thereby placed upon the utility) to connect its electric transmission facilities with those of one or more persons engaged in the transmission or sale of electrical energy, and to sell energy to or exchange energy with such persons. However, the Commission may not require the extension of generating facilities for these purposes or compel any utility company to exchange or sell energy when to do so would interfere with its ability to provide satisfactory service to its regular customers.

In case of war or a shortage of electric power or facilities, the

Commission may, upon its own motion or by request, compel a temporary connection of facilities and such generation, exchange, or transmission of power as in its judgment will best provide for the emergency and care for the public interest. For interstate purposes, the Commission has powers of control over electric utility companies similar to the powers of the S.E.C. over holding companies. That is, it controls interstate wholesale electric rates, the acquisition and sale of properties, the issuance of securities, and accounting methods. This part of the Public Utilities Act of 1935 aims to correct a weakness in the state public utility regulatory systems. In 1938, the Flood Control Act gave the Commission considerable authority in planning electric power developments at flood control dams, and in the same year the Natural Gas Act directed the Commission to regulate the transportation and sale of natural gas in interstate commerce.

The Tennessee Valley Authority

The Nature of the T.V.A. The public utility industry, in addition to its worries over the Public Utilities Act, has been much concerned about governmental competition in the production and sale of electric power. While the federal government has been building dams and facilities for the production of electric power in many parts of the country, the chief concern of the industry has been the activities of the Tennessee Valley Authority. The T.V.A. is a corporation controlled by a board of three directors appointed by the President. It was organized in 1933, for the purpose of developing the Tennessee River valley area. In 1934, when the T.V.A. project included six dams, with electric plants and transmission lines, it was estimated that the total cost would be $310,000,000. By 1939, the project had grown to a ten-dam system, and the estimated cost was over $500,000,000.[12]

The public utility industry is interested in the T.V.A. because all dams that are constructed are equipped to produce electric power, which may be marketed in competition with the electricity sold by the private utility companies. In the fiscal year 1939, total sales of electricity by the T.V.A. amounted to 1,618,286,752 kilowatt-hours, with a total revenue of $5,445,198, or 3.36 mills per kilowatt-hour.[13]

[12] *Chicago Tribune,* March 9, 1938; and C. W. Thompson and W. R. Smith, *Public Utility Economics,* pp. 683–685.
[13] *Ibid.,* p. 676.

It is frequently contended that the primary purpose of the T.V.A. is to produce and sell electric power. According to T.V.A. authorities, however, this is but one purpose among many. Other interests are flood control, the improvement of navigation, the production of fertilizer and explosives, and the rehabilitation of agriculture.

The dams permit flood waters to be stored up in great lakes, and it is said that they have already prevented millions of dollars' worth of damage along the Ohio and Mississippi Rivers. The T.V.A. expects to have a nine-foot waterway opened all the way from the Ohio River to Knoxville, Tennessee, to provide low-cost transportation for freight, and to aid the farmers of the area in preventing soil erosion and improving agricultural conditions generally. So far as electric power is produced, it is held that the T.V.A. power plants are to be used as "yardsticks," to determine how cheaply electric power can be produced and transmitted, and in this way to find out whether existing rates in the district are fair and reasonable. It is also suggested that, if the private companies have to lower their rates for electricity because of T.V.A. activities, consumption will probably be increased so greatly that these companies will make larger net profits than in the past.

Criticisms of the T.V.A. The critics of the T.V.A. assert that the project is designed almost solely for the production and sale of electricity in competition with the output of private companies. They point out that the T.V.A. has erected thousands of miles of transmission lines, and that it serves scores of communities and tens of thousands of industrial consumers. They point out, further, that the electric plants of the T.V.A., when completed, will produce about half as much power as is now sold in the seven states affected by the project, and that the T.V.A. has acquired more than $110,000,000 worth of electrical facilities from private companies.[14] Citing these facts and reports that other projects similar to the T.V.A. are to be started, the critics conclude that the private electrical industry is to be destroyed, and government ownership substituted.

In allocating the costs of the total project among the three objectives—flood control, navigation, and power production—the T.V.A. decided that $279,488,335 out of the total of $505,340,021[15] should be charged against power facilities. But critics contend that this is an underestimate of the cost of these facilities, and that the dams could have been built for far less if they had not been de-

[14] *Ibid.*, p. 696. [15] *Ibid.*, pp. 683–685.

signed for the production of electric power. To allocate too little to the construction of power facilities would be, of course, to lower artificially the cost of power production at the T.V.A.

It is charged that the use of the T.V.A. plants as yardsticks is unfair to the private companies, not only because of this artificially low estimate of original costs, but also because they are unlike the private plants in the extent of industrial and residential use, load factors, taxes, interest, and depreciation charges. To have to compete with T.V.A. rates, in the face of these fundamental differences, places the private companies at a hopeless disadvantage, it is argued. The T.V.A. is also criticized because its operation has deprived federal, state, and local governments of some 4½ million dollars of taxes which used to be paid by public utility companies, and because its power is purchased largely by a few large industrial consumers instead of benefiting the general consuming public of the area.

Constitutionality of the T.V.A. In view of these criticisms, it is not surprising that utility companies have objected strenuously to the activities of the T.V.A. Indeed, some eighteen utility companies in the southeastern part of the country brought suit, asking an injunction against the sale of power by the T.V.A., on the ground that their business was threatened with irreparable injury, if not destruction. The case came to a decision in a Federal Court in Chattanooga, Tennessee, in February, 1938. The court decided in favor of the T.V.A., holding that the utility companies have no immunity from lawful competition, even if their business is curtailed or destroyed. The judge decided that the T.V.A. dams were constructed for several other purposes—including navigation, flood control, and national defense—as well as for the development of electricity. The water stored by these dams, when allowed to pass through turbines, creates electric power. This power is the property of the federal government, and the Constitution empowers the government to dispose of its property in any way it may choose. The utility companies immediately took an appeal to the Supreme Court, which refused to reverse the decision of the district court.

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1. Why are some businesses called "public utilities"? Explain.
2. Why has it been thought necessary for the government to regulate public utilities?
3. How have our courts restricted the power of public utility commissions to regulate the rates charged by utility companies?

4. Why is the valuation of public utility properties necessary? What problems arise in connection with valuation?
5. What is meant by the prudent investment cost method of valuation? Explain fully.
6. Is either the total par value or the market value of the stock of a utility company a sound measure of the value of its property? Why?
7. What problems are encountered in attempting to find the original cost of a utility company's properties? Explain.
8. Do you prefer reproduction cost or original cost as a method of public utility valuation? Explain.
9. What difficulties arise in attempting to establish a fair rate of return? Explain.
10. Is any principle of rate regulation feasible other than the "fair return on a fair valuation"? Explain.
11. "Despite regulation by public utility commissions, many evils have continued to exist in the public utility industry." Explain the nature of these evils.
12. What have been the principal weaknesses of public utility commissions?
13. How have two developments of fairly recent years still further impaired the ability of state commissions to regulate the utilities?
14. What is a public utility holding company?
15. How do holding companies perform certain financial functions for their operating companies? Explain.
16. What other functions are performed by holding companies for operating companies?
17. What is meant by the pyramiding of holding companies?
18. How are power and profits concentrated in the hands of a few individuals through the use of holding companies? Explain fully.
19. In what ways have holding companies sometimes been guilty of duping investors?
20. How have evils existed in the relations between holding companies and their subsidiaries? Explain.
21. How have holding companies attempted to influence legislation and public opinion?
22. What were the purposes of the Public Utility Holding Company Act of 1935?
23. How is the Securities and Exchange Commission expected to control the financial operations of holding companies under this Act? Explain.
24. How are intercompany relations regulated by the Act?
25. What is meant by the "death sentence" clause?
26. Will the welfare of operating companies and consumers be adversely affected by the enforcement of the "death sentence" clause? Explain.
27. Has the government, through the "death sentence" clause, destroyed the investments of the holders of securities of high-degree holding companies? Explain.
28. To what extent had the "death sentence" clause been enforced up to June 30, 1945?

29. On what grounds did the Supreme Court decide that the "death sentence" clause was constitutional? Explain.
30. Explain the provisions of the Federal Power Act of 1935.
31. What is the T.V.A., and how is it related to the public utility industry?
32. Discuss the controversy which has been raging over the activities of the T.V.A.

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23. Monopolies

In many industries, though not in all, economies may be brought about through large-scale production. But even in fields where the economies of large-scale production are great, a single firm may grow to a point beyond which no economies in actual operation of the plant would result from a further increase in size—although greater size might be desirable from the point of view of efficient marketing of the product, economical financing, or bearing the risks of the business. Under such conditions, it often happens that several business plants are brought under one central control, so that all may be managed as a single business unit, though each plant is limited to the size at which it can produce most efficiently.

But the process of centralization of control need not stop here. One firm, or a group of firms, sometimes increases in size until it controls so large a part of the capacity of a whole industry that it can regulate the output of the industry sufficiently to exercise control over the price charged for its product. In such cases, whether the control over productive capacity and price is complete or incomplete, a condition of effective monopoly exists.

Combinations and Monopolies. At the outset of our discussion, we must distinguish carefully between monopolies and ordinary business combinations. A business combination, whether horizontal or vertical, may be formed in any industry without a monopoly resulting, so long as the combination controls only a relatively small part of the total output of the industry. On the other hand, a monopoly situation may arise through the growth of a single firm, or through a trade association of several otherwise independent firms, without any actual combination of business units taking place. It follows that what is true of a combination is not necessarily true of a monopoly. A combination may be a sound and desirable economic development, while a monopoly is neither of these things. Similarly, a business combination may increase its gains by effecting real econ-

omies in production rather than by charging exorbitant prices or practicing unfair tactics toward its competitors, but this is not the method used by monopolies.

In referring to a monopoly, therefore, we shall have in mind a person, firm, combination of firms, association of firms, or simple group of firms, which owns or controls a sufficient part of the productive capacity of an industry or business to enable it to control the price or prices charged by the whole industry or business for its product or products. It is impossible to say exactly what percentage of the productive capacity of an industry must be controlled in order to fix prices, for the percentage would vary considerably from one industry to another; but it is certain that monopoly powers can often be exercised by an organization which controls far less than 100 per cent.

We shall limit our present discussion to industrial monopolies. Public utilities, such as water, gas, and electric companies, were treated in the preceding chapter. These public utilities have long been recognized as "natural monopolies," that is, as businesses which can attain maximum efficiency only if given monopoly control and which, if organized competitively, would eventually turn into monopolies. Hence, public utilities have been permitted to operate as monopolies under governmental control. The railroads, which were also discussed separately, are more like public utilities than like ordinary industrial companies and have been accorded special treatment by the federal government.

The Development of the Monopoly Problem

For many years, the existence of monopoly conditions in an industry usually meant that the field was dominated by a single large firm or by a gigantic formal combination of firms. Though monopolies in this sense existed in the United States as early as the middle of the nineteenth century, the most active period in their organization was from 1887 to 1903. The early monopolies took several forms, some of which we shall describe briefly.

The Pool. One of the earliest types of monopolistic organization was the pool, which consisted of a group of firms combined for certain purposes, although they remained independent in other respects. As to method of operation, pools were of several types. The most common types divided total output, markets, or profits among the member firms according to some prearranged plan. In

general, pools were not a very successful type of monopolistic organization. Soon after a pool was formed, the individual members, or some of them, usually succumbed to the temptation to make a little money on the side by violating the pool agreement. This often meant the end of the pool, for the agreement among the firms was not enforceable at common law, since it was an agreement in restraint of trade.

The Trust. Another early form of monopolistic organization was the trustee device, or trust. The stockholders of the combining corporations would assign their stock with voting power to a board of trustees, and receive in return trust certificates representing the value of their properties. By holding a majority of the voting stock of the various companies, the board of trustees could elect the officers of these companies and control them as a unit with respect to production and prices. The board would collect dividends on the securities held in trust, and distribute them among the owners of the trust certificates. The Standard Oil Trust, first organized in 1879, was an outstanding example of the use of the trustee device. This method of organization was attacked in the courts of several states and was declared illegal, both as tending to create monopolies and as representing unauthorized activity on the part of the individual corporations.

The Extent of Early Monopolies. Regardless of types of organization, monopolies of one kind or another controlled some 40 per cent of all manufacturing capital in the United States in 1904. Many of these monopolies were incomplete, some did not last long, and others turned out disastrously from the financial point of view; but in 1904 there were 26 monopolies which controlled 80 per cent or more of the production in their respective fields. The products affected ranged all the way from asphalt, bathtubs, and bicycles, at one end of the alphabet, to tin cans, window glass, and whiskey, at the other. Moreover, there were at least 8 concerns which controlled 90 per cent or more of the production of some or all of the articles which they produced.[1] These companies were the American Can Company, the American Sugar Refining Company, the American Tobacco Company, the Corn Products Refining Company, the International Harvester Company, the National Cash Register Com-

[1] Temporary National Economic Committee, Monograph No. 21, *Competition and Monopoly in American Industry*, Washington, Government Printing Office, 1940, p. 65.

pany, the Standard Oil Company, and the United Shoe Machinery Company. Most of these companies were able to make extremely large earnings on their investments.

Modern Monopolies. Many cases of complete, or almost complete, control of industries by single companies exist at the present time. It is said that "today one company in each field controls all, or nearly all, of the nation's supply of aluminum, nickel, molybdenum, magnesium, shoe machinery, glass container machinery, and scientific precision glass, provides nearly all of the domestic telephone service . . . and operates all of the sleeping and parlor cars."[2] The companies involved are the Aluminum Company of America, the International Nickel Company, the Climax Molybdenum Company, the Dow Chemical Company, the United Shoe Machinery Company, the Hartford-Empire Company, the Bausch and Lomb Optical Company, the American Telephone and Telegraph Company, and the Pullman Company.

In other cases, "pairs" of firms control all or nearly all of the supply of certain economic goods. Examples are the United Fruit Company and the Standard Fruit and Steamship Company in the importation of bananas; the Pittsburgh Plate Glass Company and the Libbey-Owens-Ford Glass Company in the production of plate glass; the General Electric Company and the Corning Glass Works in the production of glass bulbs, glass tubing, and rod for electric lamps; the General Electric Company and the Westinghouse Electric and Manufacturing Company in the production of metal bases for electric lamps; the International Business Machines Corporation and Remington-Rand, Inc., in the production of electric accounting machines; the Westinghouse Air Brake Company and the New York Air Brake Company in manufacturing railroad air brakes; the Union Carbide and Carbon Corporation and the Air Reduction Company in producing compressed oxygen and acetylene; and the Texas Gulf Sulphur Company and the Freeport Sulphur Company in sulphur production.[3] All these examples relate to the national market of the United States. There are many other cases in which single firms or pair of firms control regional or local markets for various kinds of economic goods.

Conditions of effective monopoly may also exist in industries in which no single firm or pair of firms controls all or almost all of the output. Of the 1807 products studied from among those included in

[2] *Ibid.*, p. 69. [3] *Ibid.*, pp. 98–110.

the Census of Manufactures for 1937, there were 291 in which the leading single company controlled between 50 and 75 per cent of the total supply. In the case of 37 products, four firms accounted for the entire supply. In 164 cases, four firms produced over 90 per cent of the supply; and in 328 other cases, the part produced by the four leading firms was not disclosed (in order to prevent the identification of individual firms). There were 670 products in which the four leading concerns turned out 75 per cent or more of the supply, or in which information on this point was withheld. The general conclusion was that from two-fifths to one-half of the goods under consideration were produced in fields in which four concerns controlled 75 per cent or more of the supply.[4]

Holding Companies. In industries in which the greater part of the supply of some economic good is controlled by a few large concerns, these firms are usually combinations of formerly independent companies. In many cases, the large firms are holding companies which exist for the purpose of owning and controlling the securities of other corporations. With their own securities or with cash, they buy up at least a controlling interest in the voting stock of the corporations which are to be combined, and thus are able to control management, output, and prices. The holding company is very similar to the old trustee device, the securities of the holding company taking the place of the trust certificates and the board of directors of the holding company superseding the board of trustees. However, since many states have passed laws authorizing the existence of holding companies, this device is not automatically illegal, as was the old trustee device.

Mergers. The merger is somewhat similar to the holding company. While the holding company controls several business firms through security ownership, the merger exercises the same control through holding the physical properties of the various firms. In some instances, several corporations lose their identity in a new corporation which is organized to manage all the properties of the old firms. In other cases, one of the old corporations remains in existence and the others are merged in it. Like the holding companies, mergers are not illegal in and of themselves. The existence of one or more holding companies or mergers in a particular industry does not necessarily mean a condition of effective monopoly.

Price Leadership. Price leadership is an informal method of con-

[4] *Ibid.*, pp. 113–118.

trol. In industries in which the firms have heavy fixed costs, price-cutting is an extremely dangerous practice, especially if consumers can readily postpone their purchases. Each of the large companies knows that a price cut on its part would be swiftly followed by similar cuts by other large competitors, to the detriment of all companies concerned—and so prices tend to be maintained by the large companies, with some one company serving as the price leader. The numerous small companies which may exist in the same industry usually follow faithfully the price leadership of the large company or companies, either because they fear reprisals if they cut prices or because they believe their economic welfare will be enhanced by following the leader. In such industries, price changes seldom occur, and when they do they are introduced by all firms at about the same time. Evidences of price leadership have been found in industries producing anthracite coal, packer cans, corn products, fertilizer, canned salmon, industrial alcohol, steel, cement, agricultural implements, gasoline, non-ferrous metals, newsprint paper, glass containers, and biscuits and crackers.[5] Since price leadership involves no actual agreement or conspiracy among the firms, it is very difficult to combat.

Price Agreements. When the sellers in an industry are relatively few they may enter into actual agreements to establish and maintain uniform prices and terms of sale. Price maintenance may also result from the activities of trade associations, but we refer here to price agreements between firms which are otherwise unassociated in their respective industries. Agreements of this kind are in open violation of anti-trust laws which forbid conspiracies in restraint of trade. During the past twenty years many court decisions have been handed down against firms maintaining price agreements.

Basing-Point Systems. In some industries a system of "delivered prices" is maintained through the use of one or more "basing points." When several basing points are used, all firms in a given district charge their customers a uniform base price, plus freight from the basing point to the customer's geographical location. Frequently the actual freight from seller to customer is less than that from the basing point to the customer, and the difference goes into the seller's profit. Plants located outside a given basing-point district must ordinarily charge the same prices as those inside the district, when making sales in that district, and absorb the higher freight charges

[5] *Ibid.*, p. 123.

as best they can. Thus, a customer in a given district would be quoted the same price by all plants in the district, and by plants outside the district as well, so that price competition is eliminated. The firms which operate basing-point systems often claim that these uniform prices are only "asking prices," and that actual prices charged and received may differ somewhat from one firm to another. Basing-point systems have been used in the steel industry, the cement industry, and some 50 other industries.

Patent Pools. Effective monopoly has been maintained in some industries by means of patent pools. When important patents are owned by a small number of large firms, each firm may grant licenses to the others to use its patents, or all firms may pool their patents. This group of firms may then use its resources to exclude new producers from the general field of production, by refusing to grant licenses to outsiders or by charging very high royalties for the use of patents. When licenses are granted to new firms, the members of the pool may attempt to control output, markets, or prices charged by such newcomers. Patent pools do not always lead to effective monopoly, but the courts have found patent-pool monopolies among producers of ophthalmic lenses, porcelain insulators, radios, and gasoline.[6]

Other Control Methods. In addition to the methods of maintaining effective monopoly which have already been described, market-sharing is sometimes practiced by the few large firms in a given industry. Market-sharing means simply that the firms do not compete against each other for the same customers. Each firm has a particular share of the general field, and works it exclusively. Market-sharing seems to be common among investment bankers, has been practiced by meat packers and anthracite coal producers, and is said to have been used in the tobacco industry, at least in the marketing of certain products.[7] Again, control in some industries has been achieved through interlocking directorates, stock ownership, financial relationships of the firms with a common financial organization, and in other ways.

Trade Associations. Formal organizations of firms in modern industry usually take the form of trade associations or industrial institutes, which are voluntary, mutual benefit associations having as their members the various business firms in a certain trade or industry. A trade association may be incorporated or unincorporated.

[6] *Ibid.*, p. 159. [7] *Ibid.*, p. 176.

It is usually controlled by a board of directors elected by the members and is financed by dues. The members are independent in most respects and may ordinarily enter or leave the association at will. Trade associations have many legitimate fields of activity, such as "cooperative industrial research, market surveys, the development of new uses for products, the provision of traffic information, the organization of employment bureaus, collective bargaining with organized labor, mutual insurance, commercial arbitration, the publication of trade journals, joint advertising and publicity, and joint representation before legislative and administrative agencies." [8]

But their activities may also include "the establishment of common cost accounting procedures; the collection and dissemination of statistics; the operation of price reporting plans; the standardization of products, terms of contracts, price lists, and differentials; the provision of credit information; the interchange of patent rights; the administration of basing-point systems, the joint purchasing of supplies, and the promulgation of codes of business ethics; each of them practices which may operate to restrain competition in quality, service, price, or terms of sale." [8] There were in 1940 some 2000 trade associations of national scope in the United States, hundreds of which have been involved in anti-trust proceedings of one kind or another.

The Case Against Monopolies

The Efficiency of Monopolistic Concerns. While cases of complete monopoly in the hands of a single company are rare in the American economy, there are many cases in which a single firm, or small group of large firms, controls a sufficiently large part of an industry to give it effective monopoly control. The attitude of most people toward complete and partial monopolies has for many years been one of acute distrust and opposition. Though not all monopolies have been successful, many have been highly so, and in most cases the reason for success seems to have been the control over production and prices, rather than any unusual economies in operation or elimination of waste. The advantages of large-scale production are many and well known, but most of them reach a limit rather quickly, and do not go on increasing indefinitely as a firm grows in

[8] *Ibid.*, p. 226.

size. Monopoly control is not required in order to reap these advantages.

Other advantages, not available to a single large-scale firm, may be enjoyed by certain types of business combination. They may avoid competitive duplication of plant, and of advertising and selling effort. They can eliminate a large number of competing brands, and avoid "cross-hauling" by filling each order from the nearest plant. When a period of poor business hits an ordinary industry, it may be necessary for all plants to run at part capacity, and thus run inefficiently. A combination, however, can often close some plants completely and keep others running efficiently at full capacity. The several plants controlled by a combination may be made to specialize in different phases of its production, and rivalry between plants may be used as a stimulus to greater efficiency. Finally, any new processes or machines owned by any one of the firms may be used by all when all are members of a combination; otherwise, each plant would usually have its own trade secrets and special methods, and no one plant would have access to all of the best methods of production. This list of advantages, though not exhaustive, is imposing; but a few moments' reflection will convince the reader that a business combination need not be a monopoly in order to enjoy these advantages. Little statistical evidence is available as to the costs of production of monopolies, but the little that we have suggests that these costs are very seldom much lower than the costs of independent concerns or of combinations which lack monopoly powers.

Monopoly Prices. Since monopolies may claim but few, if any, economies as distinctly their own, it is evident that their success has almost always been due to restricting output and charging monopoly prices. The result has been large profits at the expense of consumers. It is, of course, very difficult to determine the exact effect of monopoly control over prices. To do this, we should have to compare the monopoly price with the price which would have prevailed under competitive conditions. Since there is no way to determine the latter, this comparison cannot be made. We know, however, that the prices charged under monopoly have usually been sufficiently high to yield large profits. It is true, as some defenders of monopolies have said, that prices in certain controlled industries have been stable or have even declined at times, but it is also true that monopoly profits may be gained without price increases. A stable price

will yield large profits if it is high enough in the first place, or if it is accompanied, over a period of time, by falling costs of production. Even a falling price over a period of time will be highly profitable if costs fall more rapidly than the price itself.

The profits made by monopolies are a fair indication of the effect of monopoly control upon prices. For example, among the early trusts, the original Standard Oil Company had earnings which ranged between 48.8 and 84.5 per cent on its investment, and averaged 61 per cent between 1896 and 1906.[9] The Aluminum Company of America made a net income of $335,000,000 over a fifty-year period, though its original investment was only $2,000,000.[10] Among the two-firm monopolies, the Texas Gulf Sulphur Company had an average annual profit of 28.75 per cent on its investment from 1919 to 1938, and paid dividends over a period of eighteen years which averaged 95.46 per cent annually on the original value of its stock; and the Freeport Sulphur Company, over a period of twenty-five years, has paid average annual dividends of 24.75 per cent on the ledger value of its stock.[11] It is clear that such profits can be made only from prices which are well above the cost of production level, whatever may happen to the absolute level of the prices. From the point of view of society, then, one of the principal objections to monopoly is its effect on prices and the burden thus placed on the consumers of monopoly products.

Unfair Tactics of Monopolies. When the smaller firms in an industry operating under monopoly conditions have refused to cooperate with the monopolistic firms, or when new competition has sprung up, the monopolistic firms have often resorted to unfair tactics to attain their ends. These monopolistic firms, with large or national markets, have often engaged in local price-cutting. That is, in areas in which they have had competition, they have cut prices to the cost level, or even below cost if necessary, in order to force their competitors to take losses. Meanwhile, they themselves have been able to "break even" or make money by continuing to charge high prices in non-competitive areas. The Standard Oil Company was a notorious follower of this policy of "cut-throat competition," but there were many others.

Firms that controlled a tremendous volume of business were once able, by playing one railroad against another, to secure rebates on freight rates, or to induce the railroads to establish particularly fa-

[9] *Ibid.*, p. 66. [10] *Ibid.*, p. 72. [11] *Ibid.*, p. 110.

vorable rates out of the cities from which these firms shipped most of their products. The Standard Oil Company once made an arrangement whereby it not only received a substantial rebate on its own shipments, but also received a similar sum from the freight payments made by its competitors. The unfairness of such a policy is apparent.

Monopolistic firms have sometimes ordered dealers selling their products to refrain from handling the products of competing companies, thus limiting the market open to competitors. The International Harvester Company, among others, used these "exclusive dealer arrangements." A similar device was the "tying contract." The United Shoe Machinery Company, for example, leased indispensable machines on which it held patents, but required the lessee to contract also for the use of other machines on which the patents had expired, and which were offered by other firms at lower figures. In this way, the company forced shoe manufacturers to use its machinery exclusively, and thus destroyed competition.

Sometimes, monopolistic firms have interfered with the flow of services and supplies needed by their competitors. They have persuaded or forced banks to cut off credit, and to call in the loans of competing firms, and have led newspapers and periodicals to refuse competitive advertising. Railroads have been induced to develop sudden "shortages" of freight cars of the necessary type; and sellers of raw materials have been persuaded not to fill the orders of competitors, or to fill them with inferior materials or only after long delay.

When public feeling against certain monopolies has run high, they have often made it appear that firms under their control were independent. Those who might refuse to buy from the monopoly would buy from these "bogus independents," and these companies could compete with the genuine independents without their fraudulent nature becoming known. Many monopolistic firms have brought spurious lawsuits against competitors, charging patent infringement or other injury. These suits would often tie up the business of the competitors and involve them in heavy legal costs, even though the suits were eventually dismissed. Competitors have sometimes been intimidated by the mere threat of such suits. On the other hand, monopolistic firms have infringed upon the patent rights of competitors or appropriated trade secrets gained through espionage or bribery, confident that they would make more through these ille-

gitimate acts than any amounts which the courts might award the competitors by way of damages. Customers of competitors have been bribed to cancel orders or to default on payments, and valued employees have been bribed to leave the employ of competitors.

Finally, monopolistic concerns have sought to damage their competitors' products or reputations. For instance, the National Cash Register Company is said to have "doctored" machines made by competitors so that they would break down or fail to work satisfactorily. The same company bought up competitors' machines from their users and offered them for resale, displaying them as "junk" or as "inferior products" at 30 cents on the dollar.

Monopolies and Business Cycles. Monopolies have also been charged with increasing the instability of our economic system. In periods of good business they maintain stable prices for their products in the face of increasing production and falling unit costs, and without increasing the wages of labor significantly. Such policies, in spite of all that can be done to support consumption through installment selling or other credit devices, lead eventually to business breakdown and depression. And in periods of depression, the monopolies are likely to hold their prices at the customary level, taking losses by selling fewer units at the stable price rather than by selling more at a lower price. This policy results in laying off labor, curtailing purchases of materials and supplies, and reducing consumer purchasing power, and eventually affects all industries and adds to the cumulative downward spiral of depression. Some economists hold that cyclical swings in business can never be eliminated, or even greatly reduced in severity, so long as many of our most important industries are controlled by monopolies with their rigid or "sticky" prices.

Monopolies and Economic Progress. Monopolies may also operate as a bar to economic progress. Virtually complete monopolies need not worry about developing new methods and processes or making new inventions, for their profits do not depend upon continuous progress in production. Indeed, they may even go to the other extreme and acquire control of new inventions by fair means or foul, only to put them on the shelf for a long time so that they will not overturn existing conditions in the industry. However, in certain industries which are dominated by a few large concerns, there has often been keen competition in the field of technological improvement; and the public has frequently benefited by this sort of competition.

Monopoly Control of the Whole Economy. It is sometimes asserted that the monopoly problem goes far beyond the question of monopoly control in particular industries—that our gigantic industrial and financial concerns not only control individual industries, but have extended their control to the economy of the United States as a whole, to the government of the country, and even to its public opinion. These conclusions are based on data dealing with the concentration of economic power in this country.

It is estimated that corporations now transact from 60 to 65 per cent of the total volume of business in the United States, and own almost 80 per cent of all business wealth. Moreover, the ownership of corporate wealth is concentrated in a relatively few large corporations. In 1937, 228,721 corporations with assets of less than $50,000 each made up 55 per cent of all corporations, but owned only 1½ per cent of total corporate assets. The 394 largest corporations owned about 45 per cent of all corporate assets, though they comprised less than one-tenth of one per cent of the total number of corporations.[12] There were some 30 "billion-dollar" corporations in the United States. The largest were the Metropolitan Life Insurance Company and the American Telephone and Telegraph Company, each of which had larger total assets than any of 38 of our states. The smallest of these 30 corporations was richer than any one of 18 of our states.[13] The number of "billion-dollar" corporations increased to 43 during the period of World War II.

This concentration of business wealth in the hands of relatively few large corporations is general throughout the leading fields of industry and finance. In 1936, the 200 largest non-financial corporations had total assets of over $75,000,000,000, or about one-fourth of the national wealth. The three largest industrials (Standard Oil Company of New Jersey, United States Steel Corporation, and General Motors Corporation) had total assets of $5,209,200,000; the three largest public utilities (American Telephone and Telegraph Company, Consolidated Edison Company of New York, Inc., and Commonwealth and Southern Corporation) had total assets of $6,548,300,000; and the three largest railroads (Pennsylvania Railroad Company, New York Central Railroad Company, and Alleghany Corporation) had total assets of $6,958,000,000.[14] In 1933,

[12] Temporary National Economic Committee, *Final Statement of Senator Joseph C. O'Mahoney*, Washington, Government Printing Office, 1941, p. 7.

[13] *Ibid.*, p. 5.

[14] National Resources Committee, *The Structure of the American Economy*, Washington, Government Printing Office, 1939, pp. 274–276.

the 50 largest financial corporations had total assets of some $35,000,000,000. The three largest banks (Chase National Bank, National City Bank, and Guaranty Trust Company) had total assets of $6,078,600,000, and the three largest insurance companies (Metropolitan Life Insurance Company, Prudential Insurance Company, and New York Life Insurance Company) had total assets of $9,607,900,000.[15]

Income, Ownership, and Savings. The concentration of corporate income is similar to that of corporate wealth. In 1937, of 477,838 corporations which made income tax returns, 285,810 had no income. The corporations which had net incomes of less than $5000 made up 65 per cent of all which reported incomes, but received less than 2 per cent of the total income of all these corporations. At the other extreme, 248 corporations received 40 per cent of the total net income of all corporations, though they made up only one-tenth of one per cent of the total number of corporations with incomes. It might be thought that this concentration of wealth and income is unimportant, because the ownership of these corporations is popularly supposed to be widespread. Actually, however, the ownership of corporations is highly concentrated, for it is estimated that one-half of all dividends paid in the United States are received by stockholders who comprise less than 1 per cent of all American corporate stockholders.[16] Moreover, the situation is not improving. In 1937, the corporations with assets of $1,000,000 or more made up only 5 per cent of a group of non-financial corporations studied, but they had 88 per cent of the savings of all these corporations. The corporations with assets of less than $50,000 were 59 per cent of the total group but had no savings at all.[17]

Interlocking Interests of Large Corporations. The mere fact that economic power is largely concentrated in relatively few corporations does little to support a claim of monopoly control of the whole economy unless it can be shown that these large corporations work together as a group toward this end. This seems to be the case. In 1937 there were 3544 directorships on the boards of the 200 largest non-financial and the 50 largest financial corporations, and these directorships were held by 2725 individual directors. One director held 9 such posts among the 250 corporations, and there were 83

[15] *Ibid.*, p. 298.

[16] Temporary National Economic Committee, *Final Statement of Senator Joseph C. O'Mahoney*, p. 8.

[17] *Ibid.*, p. 9.

men who held 4 or more directorships. Of these, 59 were active in the affairs of at least one of the corporations which they served.[18]

The National Resources Committee found that companies controlling 62 per cent of the total assets of the 200 largest non-financial and 50 largest financial groups were members of 8 large "interest groups," which combined industrials, railroads, and public utilities with financial organizations in informal communities of interest. The so-called Morgan-First National interest group included 13 industrials, 12 public utilities, 5 major railroad systems, and 5 banks. These companies had total assets of over $30,000,000,000. The Kuhn Loeb group included 5 major railroad systems, 2 other railroads, 1 utility, and 1 bank, with total assets of almost $11,000,000,000. The smallest of the 8 interest groups was the Boston group, which comprised 4 industrials, 2 utilities, and 1 bank, with total assets of less than $2,000,000,000.[19] There was also said to be much overlapping and interconnection between these interest groups.

Controlling the Government. That the large business and financial interests of the country are organized into pressure groups, for the purpose of influencing and controlling our various governmental units, seems hardly open to question. According to a recent government study, these pressure groups include such organizations as the Chamber of Commerce of the United States, the National Association of Manufacturers, the Edison Electric Institute, the Association of Life Insurance Presidents, the Association of American Railroads, the American Bankers Association, the Investment Bankers Association of America, the American Iron and Steel Institute, the American Petroleum Institute, the National Lumber Manufacturers' Association, the National Coal Association, the Copper Institute, and such closely related groups as the American Bar Association and the American Newspaper Publishers Association.[20] There are, of course, other pressure organizations representing workers, farmers, and other groups, but in general the forces of business and finance are better organized and have far greater resources and staying power.

[18] Temporary National Economic Committee, *Progress Report of the Executive Secretary, January 15, 1941,* Washington, Government Printing Office, 1941, p. 11.

[19] National Resources Committee, *The Structure of the American Economy,* pp. 306–317.

[20] Temporary National Economic Committee, Monograph No. 26, *Economic Power and Political Pressures,* Washington, Government Printing Office, 1941, pp. 14, 15.

The methods used by pressure groups in attempting to influence the government include working for "favorable" candidates for legislative and other offices, and against other candidates; lobbying for the passage of desired legislation and to prevent the passage of unfavorable laws; opposing the administrative agencies charged with the duty of enforcing laws affecting business and finance; fighting unfavorable laws through the courts and advising members to disregard the laws until court decisions have been reached; trying, in later elections, to bring about the election of legislators who will repeal or amend unfavorable laws; and working later for the repeal or amendment of these laws. The efforts of business and financial interests to influence the government are not always successful, but they are effective in many cases.

Control of the Press. A considerable measure of control over the newspapers of the country aids our business and financial groups in their efforts to dominate the American economy. Many pressure organizations which represent business and finance have large funds available for advertising, supply newspapers with "canned" articles and editorials, and in general try to keep on cordial terms with the publishers of important papers. The newspaper publishers frequently reciprocate. In the struggles between business and labor or business and government, the business side of the controversy is presented favorably by the press. Labor is commonly held responsible for industrial disputes and for any violence which results, while the government is represented as the prosecutor if not the persecutor of business. In addition to "editorializing" the news, some newspapers have suppressed or "toned down" news unfavorable to leading advertisers. On the basis of the picture presented in the last few pages, many people conclude that the problem of monopoly today goes far beyond that of price and production control in particular industries.

Attempted Solutions of the Monopoly Problem

Checks on Monopoly Powers. Even in the absence of governmental interference, the effects of monopoly control are not always so bad as they are painted. A monopoly must exercise some care as to how high a price it charges, or it may cause customers to turn to substitutes or competition to develop in the form of new firms attracted by large profits. Monopolies may conceivably moderate their policies for fear of stirring up public opinion, or because of a sense

of justice or fairness on the part of their management. Even more likely, the management of a monopoly may become stagnant or inert, and fail to take full advantage of its powers and opportunities. Finally, even if a monopoly is determined to exploit the public to the utmost, it may not be possible to determine the exact price which will bring in the greatest possible total net return.

However, the people of the United States, with their strong distrust of monopolies, have not been willing to depend upon the semiautomatic forces described above to restrain the monopolies in the use of their powers. Since the monopoly movement constitutes a problem which is national in character, we have demanded federal legislation dealing with its abuses. The basic law, the Sherman Anti-Trust Act, was passed in 1890, shortly after the start of the monopoly movement but before the most active years of monopoly development.

The Sherman Anti-Trust Act. The Sherman Anti-Trust Act was a rather brief, though important, document. It declared illegal all contracts, combinations of business firms, and conspiracies, in restraint of interstate or foreign commerce. It made guilty of a misdemeanor every person who monopolized, attempted to monopolize, or combined or conspired with any other person or persons to monopolize, any part of the trade or commerce among the states or with foreign nations. It declared illegal all contracts, combinations, and conspiracies in restraint of trade in a territory of the United States, in the District of Columbia, or between either of these and any state, states, or foreign nations. The term "person" as used in the Act was defined as including corporations and associations.

Penalties for the violation of these provisions were set at a fine not exceeding five thousand dollars, or imprisonment not exceeding one year, or both. Persons suffering damages as the result of violations of the Act could sue the guilty parties in the federal courts and recover triple damages, plus costs. The circuit courts of the United States were given authority to prevent and restrain violations, by injunction or otherwise, upon petition of the district attorneys and after hearings had been held. These courts were empowered to summon witnesses from any part of the country. The property of any violator, intercepted in the course of interstate or foreign commerce, was declared forfeited to the United States.

Enforcement of the Sherman Act. At first glance it would seem that Congress, in passing the Sherman Act, had forged a powerful

weapon for dealing with monopolies. However, the Sherman Act was quite ineffectual for many years, and the period of most active monopoly formation—1897 to 1903—occurred after its enactment. This early ineffectiveness of the Act was attributable to several causes, including uncertainty of the exact meaning of certain parts of the law, lack of funds with which to enforce it, the apathy and incompetence of the attorney-generals and their subordinates which led to poorly drawn indictments and inexpert pleading of cases, and the lack of public support. In 1895, an important case involving the sugar trust, United States *vs.* E. C. Knight Company, was decided in favor of the trust in such manner as to throw doubt upon the federal government's power to deal with monopolies. The Supreme Court held that the government had proved only the concentration of industrial control in the industry and not restraint of interstate or foreign commerce.

A few years later, two decisions favorable to the government put new life into the Sherman Act. In 1899, the Supreme Court unanimously upheld the decision of the Circuit Court of Appeals dissolving the pool between the Addyston Pipe and Steel Company and five other corporations, all engaged in the manufacture of cast-iron pipe, and enjoining the pool members perpetually from carrying out their agreement. In 1904, the Northern Securities Company case decided definitely that the Sherman Act applied to holding companies, whenever these companies operated to restrain interstate or foreign commerce. The Northern Securities Company, by giving its own securities in exchange, had acquired almost complete control of the Northern Pacific and Great Northern Railroads, and would have operated to eliminate competition between these two roads. These two decisions encouraged the government to bring further suits, and discouraged the formation of additional monopoly organizations.

The Rule of Reason. In the cases involving the Standard Oil Company of New Jersey and the American Tobacco Company, both of which were decided in 1911, the Supreme Court developed the now famous "rule of reason" for deciding such cases. Although the Court had thrice decided that the Sherman Act applied to *all* contracts, combinations, and conspiracies in restraint of interstate or foreign commerce, it now held that the Act was meant to apply only to "unreasonable restraints" on such commerce.

The Court suggested that the Sherman Act had been worded so strictly because of the many new types of contracts and combina-

tions which were being developed, and the desire of the framers to see to it that no monopoly escaped merely because of the form in which it was organized. The contracts, or other acts, prohibited in the law were not explicitly defined and the classes of acts prohibited were so broad that almost any activities of business men might come under the influence of the Act under certain conditions. Thus, it was held, the use of reason became indispensable in deciding whether particular business activities had or had not brought about the wrongs which the statute prohibited.

As Justice Brandeis put it in 1918, in the case of the Board of Trade of the City of Chicago, *et al.*, *vs.* the United States: "Every agreement concerning trade, every regulation of trade restrains. To bind, to restrain, is of their very essence. The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition." In spite of the development of the rule of reason, the Supreme Court decided that both the Standard Oil Company and the American Tobacco Company were operating in violation of the Sherman Act, and they were ordered to dissolve within a reasonable period of time. Later on, however, under the interpretation of the rule of reason, a government case against the United States Steel Corporation was decided in favor of that company.

The Clayton Act. Because the Sherman Act was not wholly successful in carrying out the purposes of its framers and because there was need for further clarification of its provisions, two additional laws were passed by Congress in 1914. The first of these, the Clayton Act, with certain qualifications, prohibited local price discrimination and the use of tying contracts. Because of the popularity of the holding company device, the Act specifically provided that holding companies were illegal if their effect was to lessen competition substantially in any industry, to restrain commerce in any section or community, or to create a monopoly in any line of commerce. It was also provided that, after 1916, no person should be at the same time a director of two or more corporations engaged in commerce, other than banks and common carriers, any one of which had a capital, surplus, and undivided profits of more than $1,000,000, if such corporations were, or had been, competitors, so that the elimination, by agreement, of competition between the firms would constitute a violation of the anti-trust laws.

Violations of the anti-trust laws by corporations were thereafter

to be considered as violations by the directors or other officers who were responsible for the illegal activities, and these officials were to be subject to the penal provisions of the anti-trust laws. Labor organizations and certain types of agricultural associations were exempted from the provisions of the anti-trust laws. Responsibility for the enforcement of these laws was vested in the Federal Trade Commission for industrial combinations, the Federal Reserve Board for financial institutions, and the Interstate Commerce Commission for combinations in transportation. The Clayton Act constituted an addition to, rather than a change in, the anti-trust law as set up in the Sherman Act, for government suits against monopolies continued to be brought under the Sherman Act. The Clayton Act was also intended to be a preventive measure in connection with monopoly formation rather than, as in the case of the Sherman Act, a cure for monopolies after they had been formed.

The Federal Trade Commission Act. A commission of five members, appointed by the President, for the administrative regulation of business conduct was created by the Federal Trade Commission Act, which like the Clayton Act, was passed in 1914. The principal powers of the Federal Trade Commission were (1) the investigation, and (2) the prevention, of unfair competition.

In the field of investigation, the Commission was empowered to gather and compile information concerning the organization, business conduct, practices, and management of any corporation engaged in commerce, except banks and common carriers, and to require such corporations to make regular or special reports, or to answer specific questions. It could, upon request of the President or either house of Congress, investigate and report the facts concerning alleged violations of the anti-trust acts by any corporation. When requested by the Attorney-General, it could investigate and make recommendations for the readjustment of the business of any corporation alleged to be violating the anti-trust laws, and, when requested by the court, could ascertain and report an appropriate form of decree in any suit in equity under the anti-trust laws, and investigate the manner in which any final decree in an anti-trust case had been or was being carried out. It could make public, from time to time, such portions of its information as it deemed expedient in the public interest.

With regard to conditions of competition, the Act declared that unfair methods of competition in commerce were unlawful, and the

Commission was directed to prevent persons and firms from using such unfair methods. The Act did not specify what were or were not unfair methods of competition, so that the Commission was granted a wide territory within which to exercise its judgment. If the Commission had reason to believe that a person or firm was using unfair methods, it could serve a complaint, stating its charges and providing for a hearing. After the hearing, if the charges proved to be true, the Commission could order the person or firm to stop employing the objectionable methods. If the order was not obeyed, the Commission could apply to the circuit court of appeals of the district for the enforcement of the order. Once this point was reached, the court had full jurisdiction over the case and could affirm, modify, or set aside the order of the Commission. Appeals could be taken to the Supreme Court.

The Work of the Federal Trade Commission. In trying to prevent the formation of monopolies under the provisions of the Clayton Act, the Federal Trade Commission has fought such things as corporate combinations tending toward monopoly, agreements and understandings between competitors, resale price maintenance, price discrimination, and tying and exclusive dealing arrangements. In trying to maintain standards of fair competition under the Federal Trade Commission Act, the Commission has proceeded against misrepresentation of the nature, quality, origin, or value of products; sales methods embodying an element of chance or lottery; commercial bribery; and disparagement and miscellaneous interferences with competitors.

Misrepresentations of the nature of products involve selling rebuilt or renovated articles as new, or such acts as calling articles made wholly or partly of rayon by such names as silk, pongee, satin, or taffeta. In connection with the quality of products, the Commission has forbidden the representation of bath salts as a remedy for obesity, a certain hair dye as safe, non-toxic, or non-poisonous, and a bunion remedy as a permanent and effective cure.[21] In passing on the origin of products, the Commission has proceeded against blenders of liquor who represented themselves as distillers, clothing producers who implied that they were weavers of cloth, and furniture dealers who pretended to be manufacturers. Misrepresenting the value of products involves attempts to convince the buyer that he

[21] H. L. Purdy, M. L. Lindahl, and W. A. Carter, *Corporate Concentration and Public Policy*, New York, Prentice-Hall, Inc., 1942, p. 439.

is getting an unusually good bargain. In this connection, the Commission has attacked the offering of "free" goods which are not really free, advertising articles for sale at slashed prices when in reality usual prices are charged, and advertising a 6 per cent rate of interest in connection with installment sales when the actual effective rate of interest is about 12 per cent.

Sales methods involving lottery or chance are illustrated by one company's practice of selling small pieces of inferior penny candy and returning the penny to some fortunate purchasers inside the wrapper of an occasional piece of the good.[22] In commercial bribery, a seller presents gifts to employees or agents of customers, without the knowledge of the customers, in an effort to secure sales. Finally, in connection with the disparagement of competitors' products, the Commission has proceeded against butter manufacturers who stated that oleomargarine is made from coconut oil which is foul and unfit for human consumption, a producer of aspirin who claimed that he had exclusive rights to the name and that his competitors' products were counterfeit, and a newspaper publisher who made false statements about the financial condition of competitors.[23]

The Commission has not been very successful in its efforts to preserve competition and prevent monopoly, and monopoly cases have usually made up a rather small part of its total activities. Monopoly proceedings are costly, and the Commission has not had much money with which to conduct them. Moreover, the provisions of the Clayton Act which the Commission has been trying to enforce suffered from defective draftsmanship, and the courts have not been willing to interpret them in a way which would make them powerful instruments in the fight against monopoly.

On the other hand, the efforts of the Commission to prevent and eliminate unfair competitive practices have been much more successful. Its activities in this field have been many and vigorous, and its cases have fared rather well in the courts. The substantive law of trade practices is more satisfactory than the common law, for under the common law it is necessary for complaining parties to show that they have suffered special injury as a result of the practices in question. It is better to have a commission with a direct responsibility to take action against unethical practices than to depend upon court actions brought by private individuals, for such individuals,

[22] *Ibid.*, p. 450. [23] *Ibid.*, pp. 454, 455.

because of considerations of cost and the uncertainty of success, are often unwilling to bring cases into court. While the unfair practices proceeded against by the Commission have usually been those of competitors or monopolistic competitors rather than of monopolies, we should not assume that the Commission's activities have had no preventive influence in connection with monopolies. Since unfair competitive practices often gave monopolies their start or at least were of considerable aid during their formative period, it is probable that the organization of some monopolies has been prevented by the work of the Commission in this field. On the whole, the Commission's record in connection with unfair competitive practices has been creditable, even though the Commission has fallen further and further behind in its work, has suffered from inadequate appropriations, has continued to use cumbersome and time-consuming methods of procedure, and has been less blessed than some governmental commissions with high-quality and permanent personnel.

Minor Changes in the Anti-Trust Laws. During the period from 1914 to 1929, several minor changes were made in the application of the anti-trust laws. The Shipping Act of 1916 legalized agreements between steamship lines with regard to fixing rates, apportioning traffic, and other matters, subject to the approval of the Shipping Board. The Packers and Stockyards Act of 1921 classified packers, commission merchants, and stockyards for special regulation under the supervision of the Secretary of Agriculture. The Webb-Pomerene Act of 1918 legalized agreements and associations entered into for the sole purpose of engaging in export trade, or holding company arrangements for the same purpose, providing that restraint of trade within the United States did not result. The Capper-Volstead Act of 1922 legalized the organization of cooperative associations of agricultural producers, provided they operated for the mutual benefit of members, did not handle products of non-members to an amount greater in value than those handled for members, and either allowed no member more than one vote or paid no dividends on stock or membership capital in excess of 8 per cent a year.

The N.R.A. and the Anti-Trust Laws. As the post-1929 depression wore on, an increasing volume of opposition to anti-trust laws developed among business men. It was held that business instability was bound to prevail so long as business firms in an industry were not permitted to cooperate with respect to industrial capacity, output, and prices, without being subject to prosecution under the anti-

trust laws. Moreover, it was claimed that unfair methods had not been eliminated and that, under the influence of the depression, they had become more intolerable than ever.

These complaints led to the passage, in 1933, of the National Industrial Recovery Act, which authorized trade associations or other organizations of business men to draw up "codes of fair competition" for their respective industries and submit them to the government authorities for approval. These codes, after being examined at hearings attended by representatives of labor and consumers, as well as government officials, were submitted to the President and, if approved by him, thereupon constituted the laws of business conduct for the respective industries. The codes affected all firms in an industry regardless of whether they had or had not been parties to their formation.

Not only were the codes expected to enforce fair practices in the industries, but it was understood, also, that business firms would not be prosecuted under the anti-trust laws for activities which were approved under the codes. In return for these concessions to business men, the latter were required to make the codes acceptable to the government with respect to child labor, collective bargaining for employees, and maximum hours and minimum wages for their workers.

The general success, or lack of success, of the N.R.A. need not concern us here. For the present, it is sufficient to note that the codes of fair competition were rushed through and approved very hastily so that many contained provisions which encouraged the further development of monopoly conditions, under the suspension of the anti-trust laws. Of the first 677 codes, 560 contained some provision for controlling prices, directly or indirectly; 361 set up standard cost systems; 403 forbade sales below "cost"; 352 prohibited members from selling at prices below their individual costs; and 51 attempted to prevent sales at prices below some average costs of the whole industry. Ninety-one codes provided in some way for the restriction of output, by limiting the size of inventories, by forbidding increases in productive capacity without special permission, by limiting hours of operation, or by setting up fixed quotas of production or sale. Finally, some codes provided for sharing markets by prohibiting freight allowances (to keep sellers from selling in distant markets by absorbing freight), by forbidding firms to sell outside their regular market areas at prices lower than those charged at home, or by forbidding firms from selling in other zones at prices lower than

those charged by firms in the other zones.[24] Since the code system practically compelled the producers in an industry to combine, it is not surprising that the N.R.A. gave a strong impetus to the growth of monopoly powers in many industries and interfered seriously with the traditional governmental policy toward monopolies.

The Robinson-Patman Amendment. Several other current laws have a bearing on the monopoly problem in the United States. One is the Robinson-Patman Amendment to the Clayton Act, passed in 1936. The prohibition of price discrimination by the Clayton Act was concerned chiefly with the effects of such discrimination upon the competitors of the offending company. But price discrimination may have important effects upon the different buyers and their customers, and the Robinson-Patman Amendment seeks to broaden and clarify the provisions of the Clayton Act on this point.

The amendment forbids sellers to charge different prices to different purchasers of commodities of like grade and quality—unless such price differences make only due allowance for differences in the cost of manufacture, sale, or delivery—whenever such discrimination would lessen competition substantially (1) between buyer and the discriminating firm, (2) between the less favored and the more favored buyers, or (3) between the customers of those buyers. In the past, it was common for manufacturers to market part of their products at regular prices, and to sell the remainder to mail-order houses, chain stores, or department stores at low prices for sale under a different name; or to discriminate for or against these types of marketing agencies, as compared with ordinary wholesalers, jobbers, and retailers. Any such discriminations, unless they can be justified on the basis of cost, are forbidden under the Robinson-Patman Amendment.

Moreover, the amendment authorizes the Federal Trade Commission to fix and establish certain quantity limits beyond which price differences may be prohibited, even though these differences are justified on the basis of differences in the cost of manufacture, sale, or delivery. It is clear that such provisions tend to handicap distributors who have formerly purchased in large quantities and sold at low prices. The amendment itself applies only to sellers in interstate commerce, but it has been reinforced by 32 state laws with similar provisions.

The Miller-Tydings Act. The Sherman Act of 1890 was amended

[24] Temporary National Economic Committee, *Competition and Monopoly in American Industry*, pp. 260–265.

by the Miller-Tydings Act of 1937, so as to legalize contracts for the maintenance of resale prices of branded articles wherever such contracts are approved by state laws, as they are in all but four states. Price-cutting on branded articles, and especially their use as "loss-leaders" by chain and department stores, had long been a source of annoyance, both to manufacturers of the goods, who tried by extensive advertising to build up good will for their goods at regular retail prices, and to competing independent merchants, who naturally found their own trade injured by such price-cutting. Under the Miller-Tydings Act, the prices of branded goods may be controlled by the manufacturer all the way down the line until they finally reach the ultimate consumer.

The effect of the Act is virtually to eliminate price competition among the various sellers of a branded commodity. While the Act states specifically that it does not intend to legalize price-fixing as between the various manufacturers of competing brands or articles, it may develop that the power to fix resale prices of their own goods will increase, rather than diminish, the tendency of "monopolistic competitors" to cooperate with respect to price policy. Hence, the ultimate effect of the Act may be to promote the development of trust conditions in industry.

In addition to the "fair trade laws," which are the state counterparts of the Miller-Tydings Act, 27 states have "unfair practices acts." In general, these measures prohibit wholesalers and retailers from selling goods at prices lower than invoice or replacement cost, whichever is lower, plus a minimum mark-up. The amount of the mark-up is determined in various ways under the different laws, but is supposed to bear some relationship to the seller's cost of doing business.

Recent Enforcement of the Anti-Trust Laws. Since the ill-fated experiment with the N.R.A., there has been a fairly continuous attempt to enforce anti-trust legislation. Many court decisions have been handed down against firms participating in price-fixing agreements, scores of cases involving the illegal activities of trade associations have been fought successfully by the government, and there have been several cases involving basing-point systems and patent pools. Among the well-known cases were those brought against the Aluminum Company of America; the Bausch and Lamb Optical Company; the International Business Machines Corporation and Remington-Rand, Inc.; the American Medical Association; the Great

Atlantic and Pacific Tea Company; three leading drug manufacturers; the American Surgical Trade Association and 24 member firms; the American Society of Composers, Authors, and Publishers; four manufacturers of computing gasoline pumps; the three leading companies producing automobiles (in connection with installment financing); and five important producers of motion picture films.

Considerations of space make it impossible to analyze these and other individual cases in detail. In some instances the government has been unsuccessful in its anti-trust prosecutions, but it has fought many more to a favorable conclusion in the courts. In the year ending June 30, 1941, for example, the Antitrust Division of the United States Department of Justice won 58 cases and lost 6 under the Sherman Act, instituted 88 new cases, and brought 2797 new defendants into court. In the same year, it won 228 cases and lost 6 under other anti-trust laws, instituted 249 new cases, and brought 623 new defendants into court.[25] On the other hand, it is likely that some developments during World War II have undone a part of the government's accomplishment in the war against monopoly. That is to say, a very large proportion of the government's orders were placed with the extremely large firms in various industries, and it was the small rather than the large firms in various fields which tended to go out of business under the pressure of goods shortages, rationing, priorities, and stringent regulations in general during the war period.

A Final Estimate of the Anti-Trust Laws. In spite of whatever accomplishments may be credited to the anti-trust laws of the United States, we must conclude, in general, that the federal government's campaign against monopolies has not been outstandingly successful. The criminal penalties of the Sherman Act and other laws have amounted to very little. It has been extremely difficult to send men to jail for monopoly activities, and the financial penalties have been too small to be effective. The granting of triple damages to those who have suffered from monopoly activities has never constituted a serious embarrassment to the monopolies. The funds at the disposal of enforcement agencies have often been inadequate. When a large company can spend more money on a single case than governmental agencies have to spend for a whole year's enforce-

[25] *Annual Report of the Attorney-General of the United States,* 1941, Washington, Government Printing Office, 1942, p. 64.

ment activities, the prospects for the enforcement of anti-trust legislation are not bright. Business men and their lawyers are often several jumps ahead of the government, and devise new methods of doing what they want to do as the government succeeds in discrediting and eliminating their former practices. Some monopolies have been able to avoid prosecution altogether, while others have been brought into court only to escape all penalties for their activities.

When the government has prosecuted anti-trust cases successfully, and the courts have ordered the dissolution of the monopolies, these dissolutions have rarely, if ever, restored truly competitive conditions. For example, the Standard Oil Company of New Jersey, a holding company which controlled a large part of the petroleum refining business, was ordered dissolved in 1911. The dissolution, however, consisted of giving the stockholders of the holding company their proportionate shares of the stock of the underlying companies, so that these companies continued to be controlled by the same people as before. As a result, there has been some doubt as to the degree to which the successor companies have competed with each other since the dissolution. It may be argued, of course, that the dissolution prevented the trust from maintaining or further perfecting its control over the oil business as time went on, and that new companies have arisen to compete with the successor companies, even if they have not competed with one another. However, in view of the absence of price competition among the major companies in the industry at present, it must be held that the dissolution was a failure in many respects. Other examples of unsuccessful attempts to dissolve monopolies might readily be cited.

The Federal Trade Commission Act and the Clayton Act were somewhat more successful than the Sherman Act, because they represented a partial change in policy. That is to say, they followed the policy of legislative regulation and administrative supervision of competition, rather than the traditional policy of "trust-busting" and enforced competition. In recent years, however, monopolies have become more difficult to control, since many of them arise out of the activities of trade associations or result from the secret and informal cooperation of large firms between which there are no actual agreements or combinations. Finally, none of our anti-trust laws are applicable directly to the larger problem of monopoly

controls *between* rather than within industries or to the domination of the economy by large business and financial units.

Our Future Monopoly Policy

The problem of monopolies is very important, not only in its own right but in relation to other problems of economic instability, agriculture, labor, and international trade. Despite all the hullaballoo about monopolies and trust-busting, our federal government has never established and carried out a really comprehensive program against monopolies, and this fact may account for its singular lack of success in this field. The elements of a comprehensive anti-monopoly program were effectively set forth in a recent study,[26] and this program might well be made the official program. It has several phases.

General Measures. In the first place, efforts directed toward the maintenance of a high and stable level of production, employment, and income in the economy as a whole would be helpful in solving the monopoly problem. Fear of depression is partly responsible for the monopolistic practices of labor unions and the monopolistic price policies of industry, and depressions allow some firms to gobble up their competitors. Governmental policies to prevent demoralization of the market in areas where chronic surpluses exist, and to facilitate the transfer of resources from these fields to others, would also be helpful, for such areas furnish fertile fields for the development of monopolies. Again, the government might furnish assistance to new firms which would give direct competition to established monopolies. This could be accomplished through such devices as reforms of the patent laws, changes in taxation to favor young and growing firms, and the refusal to sell government war plants to large established firms.

Governmental Research and Economic Education. Anti-monopoly policies may be ineffective in the case of some industries because not enough is known about industry and market structures. In such cases, governmental research may provide the basis for more satisfactory policies. Governmental research in connection with products and productive processes might be used to make available to small firms, cheaply or without charge, a great amount of knowledge

[26] Howard S. Ellis, in *Financing American Prosperity*, New York, Twentieth Century Fund, 1945, pp. 189–196.

which large firms derive readily from their laboratories of experimentation and research, but which at present is not available to small firms. Again, consumer education, grade labeling, and the requirement of accurate and simple information concerning the physical attributes of products would help to eliminate the wastes involved in deliberate and unnecessary differentiation of products and resultant restrictionism.

Removal of Governmental or Legal Supports for Monopoly. Steps should be taken to eliminate governmental policies and legal conditions that are favorable to monopolies. Tariff protection for monopolistic industries should be sharply reduced. Taxation should be reformed, as we have indicated in other connections, to encourage the founding of new enterprises and make possible the development and growth of new small enterprises. Obstacles to interstate trade should be broken down, and federal and state laws legalizing resale price maintenance should be eliminated. Finally, our patent laws should be reformed. Firms with patents should be compelled to license them to other firms which desire to use them, firms with patents should be prevented from controlling the businesses of other firms which are allowed to use the patents, the period for which patent rights are granted should be shortened, and firms should be deprived of patents for violating the patent laws.

Strengthened Enforcement of the Anti-Trust Laws. A comprehensive anti-monopoly program must include vigorous enforcement of the anti-trust laws. The Federal Trade Commission and the Anti-trust Division of the Department of Justice should be furnished adequate funds and high-grade personnel, and should be made to collaborate more effectively than in the past. Active and persistent investigation and prosecution of individuals and firms following monopolistic practices should be waged. Congress, or the Federal Trade Commission upon receipt of a delegation of authority from Congress, should codify the law with respect to unfair competitive practices, on the basis of past experience, in order to facilitate procedure. Federal charters for corporations might well be required, in order to enforce compliance with national standards of business conduct. Penalties under the anti-trust laws should be increased and applied rigorously to responsible officers and directors as well as to corporations themselves.

Governmental Regulation, Ownership, and Operation. When it is apparent that the monopoly form of organization is more efficient

than other forms in a particular industry, direct governmental regulation, or ownership and operation, should be introduced. Regulation might be accomplished by giving to the Federal Trade Commission powers similar to those exercised by the Interstate Commerce Commission in its regulation of transportation. That is, the Commission would control the issuance of securities by monopolies, would have jurisdiction over extensions or restrictions of service or output by the monopolies, and would have the power, if necessary, to control the prices charged by monopolies for their products, and the wages paid to and hours of work required of their workers, in order to prevent the exploitation of either consumers or employees.

We should not suppose that there are no objections to such a plan for direct regulation of monopolies. There is some doubt that it would be constitutional for the federal government to assume so extensive a control over monopolistic industries, under its power to regulate interstate commerce. The control of prices and wages in particular industries by government or commission is very difficult to administer, and is likely to spread to fields which were not considered in the original plan of control. The Commission would doubtless run into the thorny problems of fair valuation of properties and fair rate of return, which have been encountered in other fields of regulation. And there might be some question whether the final result would be control over monopolies by the Commission or control over the Commission by monopolies. Nevertheless, an attempt to regulate monopolies by commission might be far preferable to leaving them to operate in more or less unhampered fashion. Finally, if the regulation of monopolies is deemed unfeasible or proves ineffective, we may find it necessary to introduce direct governmental ownership and operation of certain industries which apparently belong in the monopolistic form on the basis of efficiency and cost.

If an industry is already organized in the monopoly form and is thought to be exploiting the consumers pretty thoroughly, but if it is not certain that the monopoly form of organization is justifiable on the basis of efficiency and cost, then the government might set up and operate "yardstick plants" in the same industry. If these plants could be established with facilities transferred from other fields of production in which chronic surpluses existed, so much the better. The yardstick plants would produce the same products

as the monopolized industries and would sell them, as nearly as possible, on the basis of cost of production. In this way, it would be hoped, the prices charged by the erstwhile monopolies would be beaten down, the exploitation of consumers would be stopped, and private enterprises might even be induced to enter the same fields.

Conclusion. Apparently, then, an effective attack on the monopoly problem involves a comprehensive set of measures, and we may wonder whether any federal administration would ever find it politically feasible to adopt such a far-reaching group of policies. Indeed, having seen what it would involve, we may well wonder whether we want an effective attack to be made on the monopoly problem. If we do, the means are available and it is not too late to start. The result of the program, we hope, would be both relief from the monopoly problem and the continued operation of our economic system on the basis of capitalistic institutions and price relationships.

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1. Distinguish between business combinations and monopolies. What is the significance of this distinction? Explain.
2. Explain the principal characteristics of the pool and the trust as types of monopoly organization.
3. How important were monopoly organizations in the United States as of 1904?
4. What are some examples of complete or almost complete monopoly control in American industry at the present time?
5. "The dominant concerns in many American industries are either holding companies or mergers." Explain.
6. Show how monopoly conditions may exist in an industry even though there is no one firm or formal combination of firms which controls all or almost all of the industry's productive capacity.
7. What is the importance of price leadership, basing-point systems, patent pools, and market-sharing in connection with modern monopolies? Explain.
8. "The operation of trade associations may or may not result in monopoly conditions." Explain.
9. When monopolies are highly successful, is the reason usually found in the fact that they are able to achieve greater efficiency in production than other business units? Explain.
10. What have been the usual effects of monopoly control on the prices of the products sold by the industries in question?
11. How have monopolies employed unfair competitive tactics in acquiring and maintaining control over certain industries? Explain.

12. On what grounds may monopolies be charged with contributing to business instability?
13. Indicate the extent to which corporate wealth, income, security ownership, and savings are concentrated in the United States today.
14. Is there any evidence that large industrial and financial concerns cooperate for purposes of economic control? Explain.
15. Why is it sometimes charged that large industrial and financial concerns attempt to control the government and the press?
16. How did the Sherman Act of 1890 attempt to deal with the monopoly problem, and with what success? Explain.
17. Explain the meaning of the "rule of reason" and its importance in connection with the enforcement of the Sherman Act.
18. What were the principal provisions of the Clayton Act of 1914? How was this Act related to the Sherman Act?
19. Describe the chief powers given to the Federal Trade Commission by legislation passed in 1914. Has the Commission been able to exercise these powers effectively? Explain.
20. What was the status of the anti-trust laws under the N.R.A.?
21. What was the effect of the N.R.A. on the monopoly problem in the United States? Why?
22. Show how laws, such as the Robinson-Patman and Miller-Tydings Acts, have had a bearing on the monopoly problem in recent years.
23. Comment on the enforcement of the anti-trust laws in recent years.
24. Has the government's program for dealing with the monopoly problem been successful, on the whole, up to the present time? Explain.
25. What should be our future policy with regard to monopoly? Explain.
26. Indicate some of the measures which should be included in a really comprehensive anti-monopoly program.
27. "One important thing which the government should do in connection with an anti-monopoly program is to stop supporting monopolies through policies of its own." Explain.
28. How could the enforcement of the anti-trust laws be strengthened?
29. Indicate some of the problems involved in the direct regulation of monopolies through a commission.

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PROBLEMS OF COLLECTIVISM AND FASCISM

24. Socialism and Communism

Many people feel that it is useless to attempt, as we have done, to deal with economic maladjustments, such as the problems of banking, agriculture, and transportation, as separate and distinct matters susceptible of solution without reference to other problems. To these people it appears that such problems are merely symptoms which indicate that our competitive, capitalistic economic system is already, or is rapidly becoming, unworkable. If this is true, the attempt to treat these symptoms individually is doomed to failure. Those who hold this view, whom we call collectivists, believe that our traditional economic system should be abandoned and some type of planned economy substituted for it. In the present chapter we shall examine in some detail the principles, and the outstanding points of strength and weakness, of two of the principal types of collectivism.

Collectivism in General

The Characteristics of Collectivism. Before considering socialism and communism as specific types of collectivism, we may list the characteristics which seem to be common to all types of collectivism. They are, according to one writer: "First, a condemnation of the existing political and social order as unjust; second, an advocacy of a new order consistent with moral values; third, a belief that this ideal is realizable; fourth, a conviction that the immorality of the established order is traceable not to a fixed world order or to the unchanging nature of man but to corrupt institutions; fifth, a program of action leading to the ideal through a fundamental remolding of human nature, or of institutions, or both; and, sixth, a revolutionary will to carry out this program." [1]

[1] Oscar Jaszi, in *Encyclopædia of the Social Sciences,* New York, The Macmillan Company, 1935, vol. xiv, p. 188.

The Condemnation of Capitalism—Distribution. In their indictment of our present economic system, the supporters of collectivism achieve a high degree of accord. To them, one of the most objectionable features of the present system is the existing inequality in the distribution of wealth and income. We have commented, in earlier chapters, upon the evils which result from economic inequality. It leads to the misdirection of production by consumers, and prevents the maximization of want-satisfaction from the goods which our system produces. It leads to inequality before the law, and inequality in influencing legislation and in political activities generally. It may also be an important factor contributing to business depressions. The collectivists are quite dismayed by the misery, suffering, vice, and crime which exist in the low-income groups, and by the luxury, waste, and extravagance indulged in by those with huge incomes. They object not merely to the extent and effects of inequality, but also to the way in which the inequality in income distribution comes about. They bemoan the fact that most people under our economic system must work long and hard for a miserable pittance, while a comparatively few favored individuals, through their ownership of land and capital, enjoy handsome incomes, often without lifting a hand in work of any kind. They condemn private property in land and capital, and believe that incomes should be paid solely on the basis of personal services rendered in production.

The Ineffectiveness of Production. Quite apart from their attacks upon present-day distribution, the collectivists have much to say about the wastefulness and ineffectiveness of capitalistic production. It is charged that there is much waste through competitive duplication of productive facilities and human labor. Collectivists delight in describing, as examples of this waste, competing gasoline service stations which often occupy three, and sometimes all four corners of busy intersections, although they sell products which are highly similar; and the half-dozen milk wagons of different companies which patrol a given city street, each serving a few consumers with dairy products which are substantially the same. Considerable waste of human and material resources also results from competitive advertising and salesmanship, which often lead merely to the transfer of customers from one competing company to another without serving any genuinely useful social purpose. Operating under the influence of self-interest and freedom of enterprise, business men, in selecting a line of production, are much more likely to consider

the possibility of profits for themselves than the welfare of society. Hence, as the collectivists point out, productive resources are wasted in turning out trivial, useless, or even harmful products, while important human wants are left unsatisfied.

The Breakdowns of Capitalism. Not only is the capitalistic economic system said to be wasteful and inefficient when it operates, but it is subject to periodic breakdowns, commonly called depressions, with economic activity at low ebb, though human wants are far from being satisfied. Although some of the conditions leading to depressions might be corrected without destroying the system, the collectivists feel that these depressions can never be completely eliminated under capitalism, for they hold that depressions are inherent in the very nature of a capitalistic system. Economic activity under capitalism is said to be chaotic and planless. The individual is left relatively free to produce what he chooses, when he chooses, and as much as he chooses, without reference to what other producers are doing or the public need for the product. With hundreds or thousands of producers operating in this fashion in an industry, there is little chance that exactly the proper amount of a good will be turned out year after year, or that the output of one industry will be properly adjusted to that of others. Periodic maladjustments and breakdowns appear to be unavoidable in such a system.

Moreover, the collectivists commonly hold that in a capitalistic system there is bound to be conflict between individual and social interests. It is to the interest of society to have every economic good produced in abundance until consumers' desires for the good are completely satisfied; but it is often to the interest of producers to restrict production, raise prices, and even to gain monopoly control for the purpose of increasing profits. Profit for society can result only from abundance, but profit for given producers comes often from scarcity and high prices; for, if a producer can make his product relatively scarce, he can often command more of other products in exchange than he could secure by maximizing his own output. Thus, in a capitalistic system, the interests of society may suffer.

This conflict between individual and social interests manifests itself especially clearly after a long period of prosperity, marked by increasing production and rising prices. As the period of prosperity continues, some enterprisers appreciate the fact that it will be impossible to keep on producing increasingly larger quantities of goods and selling them at steadily rising prices. Hence, they be-

gin to retrench in anticipation of a period of poor business. They lay off some workers, or put them on part time, and cut down their purchases of materials and supplies. Thus they reduce the purchasing power of laborers, farmers, and others, and the business of enterprisers in general falls off. They, in turn, react by further restriction of production and discharge of workers, and finally the business depression arrives in earnest. It should be noted that it is not to society's interest to have production restricted at such times. Consumers' wants for various kinds of economic goods have not declined. Society as a whole wants and needs to have production continued, or even increased, but private enterprisers, owning land and capital and faced with the actual or prospective disappearance of their profits, follow their own self-interest and retrench. In trying to protect their own interests, enterprisers may in this way do society a very ill turn. The collectivists contend that if society owned the land and capital and if business men worked for society for wages instead of profit, the situation would be vastly improved.

The Doctrines of Karl Marx. A considerable difference of opinion has existed among collectivists as to when and how collectivism will arrive. In some quarters, collectivism is regarded as an ideal future state, to be attained only through extensive preparation and hard work. On the other hand, collectivism was regarded by Karl Marx and his followers as a system which will inevitably evolve out of capitalism, and which is already on the way whether most people realize it or not. The doctrines of Marx have had such a profound influence upon the advocates of collectivism that we must examine them briefly.

The Economic Interpretation of History and the Class Struggle. Karl Marx held that economic matters are dominant in determining the course of history and that the form of government, family system, moral standards, and literature of a society are but reflections or by-products of economic activities and institutions. An important feature of capitalism, according to Marx, is the continuous class struggle. The two opposing classes are called by different names at different times in history, he said, but the struggle goes on all the time. The class struggle at present is supposed to be between the capitalist (or owning) class and the proletariat (or working) class.

Value and Surplus Value. Prominent among Marx's theories were those relating to value and what he termed "surplus value." He held that all commodities, regardless of differences in size, shape, compo-

sition, and usefulness, contain a certain common element; that is, the labor used in producing them. Capital, though useful in production, he regarded merely as past labor congealed in a more or less permanent form. The values of commodities in terms of each other depend upon the amount of socially necessary labor contained in them. For example, a commodity that takes twice as much socially necessary labor to produce as another commodity has twice as much exchange value.

From this theory of value, Marx derived his explanation of the method by which workers are exploited by capitalists. Under capitalism, the workers cannot work for themselves because they are unable to acquire the land and capital needed in production. Consequently, they must work for the capitalists who own these material means of production. As a condition of employment, the workers must turn their products over to the capitalists who are free to sell them for whatever they will bring, which will be an amount proportionate to the labor contained in the products. On the other hand, the wages which the capitalists pay to the workers need only be high enough to maintain the laborers and their families, and to permit them to raise enough children to take their places. The difference between the value created by the workers in production and the wages paid to them is called "surplus value," and goes to the capitalists as an unearned increment. The workers cannot refuse to make this bad bargain, because they are dependent upon the capitalists for a chance to work and because in a capitalistic system there is always a reserve of unused laborers waiting to take the places of those already employed. In this exploitation of the workers and appropriation of surplus value by the capitalists lies the cause of the class struggle.

The Concentration of Capital and Expropriation of the Capitalists. According to Marx, the thirst of the capitalists for gain is so great that they seize every possible opportunity to increase the amount of the surplus value. This leads to increasing misery and suffering among the workers and to the formation of an ever larger labor reserve. Moreover, it brings about an increasing concentration of capital in the hands of a few individuals; for the large enterprisers are more efficient than the small ones, and force the latter out of business, taking over their land and capital. As this process goes on, society will become more and more the victim of commercial crises or depressions until finally will come that last crisis in which the

proletariat will rise up, dethrone the capitalists, and operate the material means of production in their own interests. Eventually will come a classless order in which all workers will share the income of society and the state will dwindle away—for Marx regarded the bourgeois state as an instrument for protecting the owning class in its favored position.

Criticisms of the Marxian Theories. Marx wrote three large volumes to elucidate and elaborate his theories, and many books of criticism of his theories have appeared since his time. However, we shall be able here merely to suggest why his theories have been very largely discredited. First of all, the idea that all of man's activities can be explained in terms of his economic activities and institutions is based upon an overemphasis of the economic aspects of life. History must certainly take economic matters into account, but there are many human actions which cannot be explained wholly on economic grounds. As for the class struggle, it is obvious that there are differences between capital and labor and that their relations might be loosely termed a struggle. However, this struggle is not the only, or necessarily the most important, feature of the capitalistic system. Marx, thinking of the proletariat as an ideal theoretical class, attributed to the workers a unity of purpose and action which they do not possess. Workers have varied interests, many of which are not economic in character. Moreover, there is little reason to suppose that workers always act in accordance with their economic interests, to the exclusion of interests of other kinds. It must also be remembered that there are economic differences between different classes of labor, and these differences *in degree* may sometimes be quite as important as the difference *in kind* that exists between capitalists and laborers.

The Marxian theory of value has also been sharply and successfully attacked. According to Marx, the only element common to things which have exchange value is the labor contained in them. This contention led him to say that articles of wealth which have not been produced by human labor have *use value*, but not *exchange value*. However, as we know, natural resources which are in no sense the product of human labor have exchange value just as truly as have the economic goods produced by human labor. Marx never demonstrated that the value of a commodity depends upon the amount of labor contained in it. He merely attempted to show that there could be no other element common to different commodities—

and this is by no means the same thing. Marx also overlooked the element of utility in connection with exchange value. His analysis of value was incomplete in that it approached the question of value entirely from the side of supply. For it should be clear that utility is an element common to all goods which have exchange value, and an element which plays an important rôle in the actual pricing of commodities in our economic system.

The theory of surplus value, also, has fared badly since Marx's time. In explaining surplus value, Marx divided capital into two parts. He said that constant capital (which we would today call fixed capital) consists of such things as machinery and buildings, and is not a source of gain to the capitalist, since this capital merely reproduces itself in the value of the things produced. He regarded variable capital, used to pay wages, as the source of the surplus value and the gain of the capitalists. But if, as Marx thought, all gain to the capitalists comes from variable capital and not from constant capital, it is difficult to understand why capitalists should introduce machinery into their industries or make use of increasing amounts of fixed capital. For the greater the quantity of fixed capital goods used, the less would be the gains in the form of further surplus value. The rate of gain to capitalists would be highest in industries using much labor and little fixed capital, and lowest in industries using little labor and much capital; and yet Marx's prediction of revolution was based upon the growth of a great army of unemployed labor, which supposedly was to result from an increasing use of labor-saving machinery.

In describing the return received by the capitalists as a surplus value filched from the laborers, Marx overlooked the element of time and the important function of waiting performed by those who save and thus make possible the formation of capital. He also largely disregarded the important administrative and managerial functions which are often performed by capitalists. Finally, he failed to explain why the capitalists, under competition—since they were making a large gain from each worker used—did not bid against one another in the attempt to hire more of these profitable laborers, until they reached the point at which the contribution of the marginal worker to production equaled, and only just equaled, the wages which had to be paid to get his services.

It would seem that Marx was only a fairly good prophet, if we may judge by subsequent events. The population has not become

divided into two distinct classes, bourgeoisie and proletariat. Instead, a large middle class has continued to exist, and there are surveys which show that most individuals, whether relatively well-to-do or poor, consider themselves members of the middle class. Under the development of the corporation and industrial combinations, there has been a considerable concentration of capital, but the concentration of *control* over capital has been more pronounced than that concentration of *ownership* which was so prominent in the Marxian analysis.

The lot of the workers has not been one of increasing degradation, misery, and squalor, in an absolute sense, since Marx's time. It is true, of course, that for some years following the Industrial Revolution the trend in the condition of the working class seemed to be in that direction; but labor organization and governmental intervention in the form of labor legislation and social insurance—measures in which Marx had no faith—have helped to reverse this trend. However, it is possible to argue that workers have become relatively worse off, and that the disparity between rich and poor has increased since Marx's time. For some years we have had a reserve of idle labor and this reserve has been large in times of severe depression, but it has hardly reached the proportions predicted by Marx.

Business depressions have probably increased in severity, in the absolute sense, as our economic system has become more extensive and more complex, but it is not clear that they have become relatively more severe. Finally, the time when all material means of production will be owned by a few, and the militant masses of the population (the proletariat) will rise up in their might and destroy these few capitalists, does not indeed appear to be imminent.[2]

The Elements of Socialism and Communism

Having described briefly the indictment which collectivists bring against the capitalistic system and their basis for hoping that it will be replaced by a different type of economic order, we now turn to a consideration of the characteristic features of socialism and communism. The terms "socialism" and "socialistic," like the word

[2] For a brief but searching analysis and criticism of the doctrines of Karl Marx, the student may well read Alexander Gray, *The Development of Economic Doctrine,* New York, Longmans, Green & Company, 1931, pp. 293–329. This work has been helpful in the preparation of this brief summary of the theories of Marx.

"inflation," are very loosely used in everyday conversation. Some people regard as socialistic every extension of governmental functions, even though the new functions are calculated to uphold and strengthen the existing order and thus lessen the probability of the adoption of a different type of system. Some, indeed, are inclined to view as socialistic any governmental activity, old or new, which apparently does not serve their own particular interests, and to stamp as a socialist any person whose views on economic matters differ from their own. The term socialism, to us, means an economic system in which the material (that is, non-human) means of production are owned and managed by society. Communism includes all of this and a good deal more. For under communism consumers' goods would be collectively owned and arbitrarily distributed among the populace, in addition to land and capital being owned and operated collectively.

The Collective Ownership of Land and Capital. Under both socialism and communism, then, the material means of production—that is, land and capital—would in general be owned by society and not by private individuals. But this does not necessarily mean that all land and capital would be owned by society. Individuals might be allowed to own plots of land as home sites, and even to own the land and capital needed in the operation of small business enterprises, such as shoe-repair shops and corner stores. Some socialists question that it would be wise for society to try to own and operate the land and capital used in agriculture, which is so largely a decentralized industry. Individuals would certainly be allowed to own such goods as lawn mowers and washing machines with which to perform services for themselves; and it would be exceedingly difficult to prevent people from performing similar services for others for pay, or from hiring these goods to others on a rental basis. An insistence on the complete and absolute ownership of land and capital by society would probably weaken, rather than strengthen, the socialist position. However, the essential fact remains that, under socialism, the land and capital used in all major industries, with the possible exception of agriculture, would be owned by society, and private individuals would no longer receive rent and interest for the use of these productive agents.

Opinions differ as to the method by which land and capital would be brought under the ownership of society. It is sometimes suggested that the present owners should be expropriated by violence

and revolution. In general, it is probable that communists incline more strongly toward this point of view than do socialists. Many people realize, however, that such measures, while they might bring quick and thorough results, are subject to grave dangers. They are likely to repel all who are motivated by humanitarianism. Moreover, to cut down ruthlessly the present owners of land and capital would deprive society of some of its most capable executives and administrators. And if revolution were attempted but failed, society might well swing to the opposite extreme so that collectivism would be impossible for many years to come; but a failure to achieve collectivism by democratic processes at any one time might be followed by success a little later. Finally, if revolution resulted in a stoppage or breakdown of economic activities for any considerable period of time, an indescribable amount of suffering and loss of life would almost certainly result.

For these and other reasons, it seems that socialism, if it is to come, should await the time when a sufficient number of citizens appreciate its merits so that it can be voted into existence. But, in any event, if the land and capital are to be acquired by society, there will remain the question of whether confiscation or purchase is the better method of procedure. In general, purchase appears to be sounder than confiscation. Of course, the compensation of present owners would perpetuate, for a time, the great inequalities in wealth and income to which socialists object so strenuously. However, since the lump sums or annuities which might be granted to the present owners would not be transferable to their heirs, this problem would be a temporary one.

The Collective Management of Land and Capital. Opinions differ, also, as to the best way to manage the socially owned industries. Some collectivists think that the central government should assume direct responsibility for the management and operation of all of the socialized industries. Others hold that management should be vested in trade unions, syndicates, or even in modern replicas of the medieval guilds. In any case, the central government would have to supervise in general the operation of the entire economic system, for there are some functions which could hardly be performed by any agency other than the central government.

Such duties would probably be performed by a governmental commission, or commissions. It would be necessary for the central agency to collect and study a great mass of statistical information

relating to natural resources and other factors of production, to the wants of consumers for different kinds of economic goods, and to the extent to which these wants are currently being satisfied. This agency would have to make decisions, based upon the expressed will of the people, as to which industries should continue to operate and which, if any, should pass out of existence. It would have to decide how much of each industry's product should be made in each period, and coordinate the production of the different industries of the country so that the national income as a whole would meet the needs of this socialized people.

The Distribution of Income. An important problem under socialism or communism, as under capitalism, would be the distribution of the national income. Should economic goods be distributed directly among the citizens or should the members of society be given money incomes with which to buy such goods as are available? The communists believe in the collective ownership of consumers' goods, as well as capital and land, and would have these goods distributed directly among the people. Socialists, on the other hand, are more kindly disposed toward the use of money and the exercise of choice on the part of consumers.

Once the *method* of distribution has been decided, it becomes necessary to formulate a *principle* of distribution. Shall the national income be divided equally among the income-receiving citizens or shall there be differences in incomes, and if there are to be differences upon what basis shall the differentiation be made and to what extent? Some socialists contend that all should share alike, although it is not always clear whether this means an equal share for every man, woman, and child or equal shares as between families. Sharing equally would probably mean, to these socialists, the equal sharing of money income, while real income would vary in composition from one individual or family to another. Many socialists recognize the difficulties of getting people to work hard, or to take the more responsible and important positions in our economic system, if all persons are to have equal incomes; and consequently they advocate that there be some variations in income as between individuals, based upon differences in ability, or efficiency, or both. However, most communists, and some socialists, hold out for an entirely different principle of distribution, urging that individuals should contribute to production on the basis of their ability and receive income on the basis of their needs. This might mean that

those who contributed most heavily to production would draw the smallest incomes because their needs were slight. In general, we may consider the principles of equal distribution and of distribution according to needs, as ideals rather than practical proposals. In practice, a collectivistic economic system would probably have to tolerate an unequal distribution of income based upon the productivity of its citizens.

One thing seems certain, however. The degree of economic inequality which would exist would be very small as compared with that which we have today. Since society would own the land and capital, private individuals would not receive, under socialism or communism, any incomes from rent and interest. Of course, different pieces of land would vary in productivity under collectivism as under capitalism, but the fruits of these variations in productivity would be spread over society as a whole, whereas now they go to a relatively small group of landowners. Similarly, a collectivist society could not do without capital goods, but these goods would be furnished by society as a whole and the rewards for saving and waiting would be reaped by society as a whole. Since industries would be run by society, the enterprisers and managers would be servants of the state and would be paid a stipulated wage; they would not, of course, receive any income in the form of profits as at present. All income would be distributed in the form of wages, except that provision would have to be made, in some way or other, for those who were unable to contribute to production. While differences in income would probably be permitted on the basis of efficiency and ability, we may be quite sure that even the most important executives and managers would not draw incomes of $100,000 to $1,000,000 a year as some do at the present time. But wages *in general* would, under socialism or communism, be considerably higher than at the present time; for every worker would have included in his wage his share of social rent and interest, in addition to the payment made for his labor.

Saving and Capital Formation. While socialism or communism would eliminate most competition, as we now know it, and would greatly limit the institution of private property, we must not assume that either form of collectivism would turn its back upon all features of a modern capitalistic economic system. Production would doubtless continue to be roundabout, large scale, and specialized in character, and would require large and increasing amounts of capital.

Since collectivists frown on the receipt of interest by private individuals, the question may be asked as to how the necessary capital would be provided.

Capital formation, it will be recalled, depends upon saving. Under our present system, certain individuals must refrain from consuming to some extent, and must, in effect, elect to buy capital goods instead of consumers' goods with a part of their money incomes, if capital formation is to take place. In other words, in any society, the cost of obtaining capital goods, which will help to create a more abundant life in the future, is found in the necessity of getting along with a smaller quantity of consumable products at present than could have been obtained if the creation of capital goods had not been undertaken. In a collectivistic society, decisions as to how much to save would not be left, as at present, to private individuals motivated by the prospects of interest. Instead, the central authority would decide how much should be saved, and would carry out its decision by directing the use of a certain part of society's land and capital into the production of capital goods rather than consumers' goods. In this way, all the people would help to bear the cost of providing capital goods by having to put up with smaller real incomes currently than they would otherwise have received; and later on, when society's productivity had been enhanced by the use of this capital, presumably all would share in the greater national income.

Money and the Price System. Another pertinent question has to do with the extent to which a socialistic or communistic economic system would make use of money and the price system. Under communism it may be assumed that money and prices would not be used. Consumers' goods, when produced, would belong to society, as well as land and capital, and the consumers' goods would be distributed directly among the people in some arbitrary fashion, so that money and prices would not be needed. Labor would have to be directed arbitrarily into the proper occupations, unless we may assume that the better nature of men would cause them, under communism, to select the occupations in which they would be most useful to society. Similarly, society as a whole, through its representatives directing the system, would have to decide what goods should be produced, and in what quantities.

While some socialists have favored the use of labor certificates or similar substitutes for money, most socialists are at present resigned to the use of money and to some dependence upon prices. For one

thing, prices would probably be used under socialism to direct the labor supply into the desired occupations. Land and capital, being owned by society, could be arbitrarily distributed among different industries and occupations without any great harm being done. The labor supply, however, is made up of human beings who have home ties and other associations which would make it undesirable for the central authority to shunt them from one occupation to another and from one part of the country to another in an arbitrary fashion. Consequently, socialism would probably rely upon differential wages, as far as possible, to get labor to move from one industry to another and from one locality to another in order to keep the labor supply distributed in accordance with the changing needs of society. Thus, if more workers were needed in baking bread and fewer in producing motion pictures, the wages of bakers would be raised and those of motion picture workers lowered, until workers had shifted from one occupation to the other in desired numbers, or at least trained their children to become bakers rather than actors, directors, or cinematographers.

A socialistic system would probably also depend upon prices, to a considerable extent, to get the products of industry rationed among the people as consumers. The use of prices is probably the best way to allow consumers to choose what they will consume and to permit a variation in the composition of real income as between individuals. Since society would control both the total amount of money to be given to citizens and the prices at which products would sell, it should be quite possible to distribute the output of industry among the people while giving them considerable freedom of choice. The total amount of want satisfaction derived from the national income would probably be much greater, with the use of prices and the exercise of freedom of choice, than it would be if goods were rationed directly to the consumers in certain fixed quantities.

However, a socialistic system would rely less extensively than a capitalistic system upon prices. We have already seen that socialism would not depend upon prices to govern the total amount of saving and investment, or the distribution of land and capital goods among the several industries. Moreover, it would not allow prices to determine what to produce and in what quantities. The fundamental relationship now existing between prices and costs of production, under competitive conditions, would largely disappear under socialism. Since land and capital would be owned by society, any charges

made to industries for the use of these agents would be purely arbitrary. Wages would be determined by the central authority as would also the prices of finished products. Under these conditions, there would be no necessary relationship between prices and costs of production.

Let us suppose, for example, that an article produced under socialism did not, at a price equal to "cost of production," sell in the quantity in which it was being produced. Under capitalism this situation would be expected to lead eventually to a restriction of the productive capacity of the industry and a consequent reduction of output. Under socialism the output might be maintained or even increased if the central authority thought the commodity should be widely consumed by the people. Any "loss" on this article could be covered by selling other, less essential goods at prices higher than their alleged cost of production. Similarly, the ability to charge a price higher than cost of production for an article provides, under capitalism, an incentive to increase productive capacity and output, but this would not be true under socialism. Capacity and output would be expanded only if this course of action appeared socially desirable for other reasons. Prices and costs under socialism would be used merely as bookkeeping devices to aid in planning production to meet the needs of the people, and in checking up on the degree of efficiency with which plans were carried out. They would be purely arbitrary amounts, as determined by the central authority. The price system, thus administered by the peoples' representatives, would be the servant of society and not its master.

Possible Accomplishments of Collectivism

The Wastes of Competition. Such are the features which would probably characterize a collectivistic economic system. We must now attempt to see what gains the collectivists feel would be realized in the way of increasing human welfare, through the adoption of collectivism. In the first place, collectivists are convinced that a system of this kind would eliminate most of the wastes of competition. Since production would be socially controlled, there would be little danger of competitive duplication of productive facilities and human efforts such as mark capitalistic economic systems. Every industry would be organized into productive units of the most efficient size, and no more units would be set up than were needed to turn out the socially desirable amount of goods. Advertising, if it

existed at all, would be used to strictly educational and instructive ends. With production organized for use and not for profit, there would be little danger that productive agents would be used to make trivial goods so long as important human wants remained unsatisfied, or that industries which produced useless or harmful goods would be tolerated. Since production would be organized with the interests of society at heart, collectivists believe that human wants as a whole would stand a much better chance of being completely satisfied under collectivism than under capitalism.

Individual and Social Interests. We have already said that, in a capitalistic system, the interests of individual enterprisers often lead to the limitation of certain types of goods, while the best interests of society as a whole require these goods in abundance. This conflict of interests, collectivists say, would be eliminated under collectivism. Those who managed and directed the affairs of industry, being merely employees of society and unable to make profits for themselves under any circumstances, would have no incentive to restrict production in any industry. Their interests, like those of society, would be best served by producing in abundance. Moreover, it is said, collectivism would provide a remedy for the present practice of delaying the introduction of new inventions, in the interest of large profits, and consequently the best equipment and methods would be promptly available for all productive units.

It is argued, also, that the ordinary workers in industry would be more efficient under collectivism. Since they would be working for society instead of profit-seeking private enterprisers, they could count on getting their full share of the national income. As a result, labor unrest, strikes, boycotts, and other types of labor troubles should disappear. And since there would be work for all, and no fear of unemployment, there would be no incentive for workers to "soldier on the job" to make their jobs last, or to oppose the introduction of scientific methods, improved machinery, and labor-saving devices. By removing the greater part of the present conflict between individual and social interests, it is held, collectivism would contribute greatly to the efficiency of production.

The Elimination of Business Depressions. Under either socialism or communism, it is said that business depressions would be unknown. The supply of purchasing power under socialism would be completely controlled by the central government and would never be allowed to operate, as it sometimes does under capitalism, as a

force making for business booms and depressions. Production would no longer be planless and chaotic, because decisions as to what and how much should be produced would no longer be left to thousands of independent and uncoordinated individuals as under capitalism. Final decisions of these kinds would be made by the central authority, and misdirected production would not occur unless the central agency made mistakes in gauging the desires of consumers or were unable to meet these desires. Since production under collectivism would still be roundabout in character and would still be undertaken for a future market, it would be quite possible for misdirected production to occur. However, with the selling prices of products completely under the control of the central authority, it would be possible to induce consumers to take an unusually large output of some good off the market by lowering the price sufficiently or to restrict the consumption of another good, limited in quantity, by raising the price. Since costs and prices would mean little in such a system, misdirected production, when it occurred, would not be a force making for economic depression.

Moreover, under collectivism there would never be an incentive to close down an industry or to reduce its output, unless the desires of consumers for its products were completely or very nearly satisfied. In other words, the time would never come under collectivism, as it does under capitalism, when business uncertainties could cause managers to discharge workers or put them on part time, to reduce purchases of materials and supplies, and to take the other steps which today lead to the vicious downward spiral of depression. Business managers, under collectivism, would be working for society, would not receive profits in any event, and would never reduce production unless instructed to do so. Thus, it is claimed, business depressions would under collectivism be only a bitter memory.

The Employment of Labor. It is contended that under collectivism there would always be employment for all persons able to work, while generous provision would be made for those unfortunate individuals who were unable to contribute to production. In fact, all who were able to work would be required to do so in order to receive any income. Under capitalism, the ability of workers to find employment depends upon whether those persons who control land and capital can make a profit by using the workers. Under collectivism, with land and capital owned by society, workers could always be used with profit to society so long as human wants were not com-

pletely satisfied. The cost of putting laborers to work in a given line of production is, from the social point of view, only the necessity of providing them with land and capital which could otherwise be used to produce other goods. In short, the only costs would be opportunity costs, and there would be plenty of employment for labor as a whole. And if society ever managed to produce more than enough goods to satisfy the wants of consumers, it would reduce hours of work for all citizens and allow all to enjoy more leisure time. There would still be employment for all.

Saving and Investment. Finally, it is contended that the twin processes of saving and investment would be much better coordinated under collectivism than under capitalism. Under the latter system, people often desire more funds for investment in industry than are currently being saved, so that the banks have to create extra purchasing power for investment purposes. At other times, savings pile up in our financial institutions and cannot find profitable investment. These evils, it is claimed, result from leaving these processes in the control of private individuals who react to price considerations. The processes not only are carried on wastefully, but they have important repercussions in connection with business cycles. Under collectivism, saving and capital formation would mean merely that society would choose to direct a part of its productive resources into making capital goods rather than consumers' goods. Society would not be so silly as to deprive the people of consumers' goods at a given time unless there were a real need for further supplies of capital goods; and, on the other hand, society could always withhold from its citizens enough consumers' goods to make possible the creation of any required amount of capital goods, however large. Thus, saving and investment would really be a single process under collectivism.

Criticisms of Collectivism

Collectivism and the Family. It is small wonder, then, that collectivists find in the possibilities of their projected social order a picture which they think should be attractive to many who suffer from the imperfect workings of capitalism. However, it would not be fair to leave the subject of collectivism without considering some of the objections which are raised against the proposals we have described. Some of these objections are weighty indeed, while others do not

appear to be so well founded. We shall discuss the latter objections first.

There is a widespread idea in this country that socialism or communism would involve the breakdown of the institutions of marriage and the family, and that collectivists believe in "free love," the nationalization of women, or some other radical idea with respect to relations between the sexes. Now, it is undoubtedly true that some collectivists harbor extreme ideas of this kind, but so also do many individuals who are not collectivists. In general, collectivists are inclined to believe that marriage and the family would reach their most perfect development under collectivism, because these institutions would then be freed of economic considerations. With a fair distribution of the national income, an ambitious young man would have no need to marry the boss's daughter, nor would a woman be tempted, for economic reasons, to espouse a rich but otherwise unattractive individual for whom she had no real affection. No one would be forced to abstain from marriage because of economic necessity, and marriage and the family would come to have a sound basis in mutual admiration and affection.

Collectivism and Religion. In like manner, there is a popular notion that collectivists are atheists and would put an end to religious activities. Now it is true that collectivists are usually bitterly opposed to state churches, whenever these religious institutions work hand in hand with the political organization to keep the people in subjection. Undoubtedly, some collectivists are disgusted with the religious institutions of the present time; and it is likewise true that some people who are collectivists, and others who are not, convinced as they are that social reform can be accomplished here and now, are impatient with any religion which encourages people to be humble and resigned to hardship and privation in this world so that they may be more fortunate in the next. However, there is little or nothing in collectivism to support the belief that, in a new social order, religious activities of all kinds would be ruthlessly suppressed and discouraged.

The Control of Production. Not all objections to collectivism can be disposed of in this summary fashion, however. There are many people who believe that it would not be possible, as a practical matter, for society to control all economic activity. They believe that no men are sufficiently intelligent and capable to look after the eco-

nomic affairs of 140,000,000 people more efficiently than these millions can individually direct their own affairs. Regardless of the statistical data that might be assembled and the number and character of the subsidiary organizations and agencies set up, a central planning commission would find the economic activities of this country too great and too complex for effective central control. According to these critics, it would require superhuman wisdom to decide what goods should be produced, to coordinate the activities of different industries, to control the purchasing power of the country, to keep all able persons employed, to devise a fair principle for the distribution of income, and to balance properly the production of consumers' goods and capital goods. They hold that governments have always proved inefficient in operating industries, and that, if all economic activity were to be subjected to political control, the result would be chaos many-fold worse than the disorganization and inefficiency which collectivists complain of under the present system.

The collectivists naturally do not accept these objections as sound. They admit, of course, that the change from capitalism to collectivism would not endow men with superhuman wisdom and infallible judgment. Many mistakes would undoubtedly be made in planning and carrying out the economic activities of a collectivistic society. But they insist that the probable achievements of collectivism should be compared, not with the results which would be realized under a perfectly functioning capitalistic order, but with capitalism as it has been and now is. Since some critics of our capitalistic order contend that its efficiency in satisfying human wants is but little, if any, more than 50 per cent of what might be accomplished in the existing state of the arts of production, collectivists feel that there would be some gain at least under their system. Such mistakes as might be made in planning the nation's economic affairs would tend to be overcome as we gained experience in planning. At any rate, our people would probably be more tolerant of mistakes made in the attempt to serve the best interests of society as a whole than of those which admittedly result under capitalism when individuals seek their own private interests. Given adequate information and well-developed subsidiary planning agencies in the many lines of economic activity, the collectivists feel that national economic planning is distinctly feasible and well worth trying. However, despite these claims, we believe that the practical possi-

bility of social control over economic activity is still a debatable question. It is one which can be fully answered only by experience, and not in advance of the event.

The Selection of Leaders. Another important question relates to the selection of leaders—those who are to fill positions on planning commissions and manage the great industrial units. Babies do not come into the world conveniently labeled "leaders" and "non-leaders"; and the men who develop leadership under capitalism do not always show exceptional prowess or promise as youths and young men. Leaders under capitalism are forged in the crucible of experience, and reach their exalted positions, as a rule, fairly late in life. Of the many who try to become great industrialists, only a few succeed. It is thus that we develop our leaders. Under collectivism, the selective influence of competition would be lacking. How, then, could leaders be chosen?

The collectivists would probably answer that, in their system, it would not be a matter of discarding all of our present industrial leaders and developing new ones from the masses at once. If collectivism were peacefully achieved, an effort would probably be made to leave those important executives and managers, who appear to merit their present positions, in places of responsibility. It is felt by collectivists that much managerial ability goes to waste under capitalism because many persons who possess ability cannot get the training necessary to fit them for high positions, or because they lack the capital or connections to make them eligible for these posts. Under collectivism, such training would be given to large numbers of people and it should be possible to select some persons who would eventually qualify for key positions in the economic order.

Incentives Under Collectivism. Probably the most important question raised in connection with collectivism is whether, under such a system, individuals would have an incentive to work hard and make full use of their talents and abilities. Under capitalism, everyone has the incentive of personal gain to spur him on in developing his abilities to the utmost, and obtaining the highest position for which he can qualify—for large incomes and great wealth come to those who are conspicuously successful. While collectivism, as we have seen, probably would not mean absolute equality in the distribution of income, it is certain that inequality would be largely eliminated and differences in income would be very small as

compared with those of today. Moreover, the larger incomes under collectivism would at most mean merely higher standards of living. No one could pile up property rights in land and capital to insure himself later a permanent income without working, or to found a family fortune. Of course, under capitalism, not all who seek great riches actually attain them, but it is commonly held that the opportunity for economic advancement affords an incentive to all. What would be the incentives under collectivism?

The question would be important and applicable to all grades of workers under collectivism—from the head planning commissioner down to the lowliest worker. Of course, all who had the ability to do so would be required to work for their incomes, but how would efficiency be achieved among the rank and file? The man who just met the minimum requirements of his job would receive almost as much income, and have possibly as much leisure, as the one at the next machine who worked with great zeal. No one would hold any effective power of discharge over the inefficient worker, as the employer does under capitalism, because society would be obligated to furnish employment for all who were able to work. Of course, negative incentives might be provided in the form of penalties for laxity, but it is questionable how effective or desirable they would be.

What incentive would one have under collectivism to aspire to a high position in an industrial unit, with all its worries and responsibilities, if the wage paid were only slightly higher than that paid to workers in the ranks? What incentive would there be for a man in such position to be as efficient as possible, when he could not hope for profits, could not accumulate land or capital, and could not in any event pass on accumulated wealth to his heirs? Opponents of collectivism urge that, in the absence of our customary economic incentives, economic efficiency would decline and the national income would fall until, no matter how fairly it was divided, there would be poverty, and not plenty, for all. They suggest, further, that a collectivistic society would be stagnant and unprogressive, since its members would not invent new machinery and devise improved methods of production, if they could not profit personally by their use in industry.

As usual, the collectivists have ready answers to these objections. The capitalistic system, they say, does not provide incentives for all. The great inequality of wealth and income discourages the poor and

limits their efforts, while the possession of great wealth by others gives these favored persons the best possible incentive to do nothing at all. Even under capitalism, some people work hard to win the esteem and admiration of their fellow men, or because they are interested in the welfare of society as a whole. Under collectivism, in the absence of economic incentives, these other motives would flourish and develop unprecedented vigor. Moreover, some differences in incomes would be granted under collectivism and, it is held, even these differences might provide considerable incentive in the absence of large differences in income with which to compare them unfavorably. Even if it were difficult to furnish adequate incentives under collectivism for individuals who had become accustomed to such "bribes" under capitalism, it is held that after a generation or so the old system would be forgotten and the non-economic incentives of a collectivistic system would be adequate. Finally, if worst came to worst and the national income should decline or fail to grow, the collectivists suggest that people would not greatly mind being in moderate circumstances if there were none who were sufficiently well off to make them feel their poverty. So far as incentive for inventors is concerned, the collectivists point out that very few inventors reap great rewards under capitalism, since most of the profit that results from their efforts goes to business men who exploit the inventions. Nevertheless, inventors continue to work, apparently largely for the sheer joy of devising new things, or for other non-economic reasons. Moreover, many inventions have been made by university or governmental employees who have not attempted to turn their devices into private gain.

In discussing incentives we are admittedly on uncertain ground. People have long been arguing about the extent to which man requires economic gain if he is to be stirred to productive activity and the extent to which he may be spurred on by other motives. It seems clear that there are very considerable differences among individuals as to their reactions to incentives, and that the matter must be submitted to the test of further experience.

Freedom Under Collectivism. Finally, there are some people who urge that collectivism should be avoided because it could succeed, if at all, only through regimentation, and the subordination of the individual to society. A person would no longer be free to follow his self-interest in his own way, he could not choose his own field of enterprise and decide how much or how little to produce,

nor would he be allowed, as he is allowed today, to pile up wealth and spend or give it away as he might see fit. Under collectivism the interests of society would be superior to the interests of individuals. It were better by far, say the exponents of individualism, to have liberty and possibly poverty, than to enjoy a comfortable, assured income at the cost of one's freedom.

But the collectivists answer this argument by saying that most people, under capitalism, have very little freedom to lose. Political freedom they may have, but few indeed enjoy true economic freedom. Freedom of enterprise and self-interest, for most people, are a snare and a delusion. The average man chooses rather the corporation for which he will work, than the line of business into which he will go as enterpriser. The captain of industry says "Come," and thousands of people have work. He says "Go," and the same thousands are idle and must turn to charity or relief for their maintenance. He decides to lower wages and his employees tighten their belts, and grin and bear. If the workers organize in order to bargain collectively, the great industrialist attempts to smash their union, if it is of a type which he will be unable to control. If the government legislates on hours and wages, the courts void the laws and protect the workers' right to work for as low wages as they will, rather than to let their freedom of contract be destroyed. If this be freedom, say the collectivists, it is the freedom to starve rather than to earn a fair living. And hence they conclude that most people are wage slaves under capitalism and can be set free only by collectivism.

Cumulative Dissatisfaction Under Collectivism. We have now examined the most serious objections to collectivism, but we may mention two further points. There are some who contend that a system of collectivism could not long endure, because its members would become increasingly dissatisfied with the commodities and services furnished them by the government. Even now we grumble about many of the goods we buy, but our complaints are directed against many enterprisers. We feel that we are overcharged for electricity, but forget this grievance when we encounter the high price of gasoline, and we cease condemning the oil trust to complain of the outrageous price of milk. Thus, one grievance tends to cancel another; but under collectivism all dissatisfaction and condemnation would be concentrated upon the central government—the only business enterpriser. This objection is one to which no

definite answer can be made one way or another; but it seems probable that if the national income were large and well diffused, the problem would not prove to be a serious one.

The Population Question. Finally, some critics suggest that population would tend to increase under collectivism, and that this increase might lead to the downfall of the system. The theory is that population is held in check under capitalism by the desire for economic advancement on the part of the people, since too many children may keep a family from "getting ahead." Under collectivism, with jobs at good wages guaranteed to all and support assured for one's children as well as for oneself, families might increase in size to such an extent that standards of living would be sharply reduced despite our best productive efforts. Here, again, we are in the field of speculation. In Chapter 4 we noted that the number of children in a family is influenced to a certain extent, and often to a considerable extent, by non-economic considerations. Public opinion might, under collectivism, prevent an unduly great increase in numbers. Judging from our present society, we may suggest that improvements in incomes would not seem likely to lead to families of large size. In our society today, the largest families are often found among the most wretched and miserable groups. It seems possible, indeed, that the assurance of a satisfactory income to all workers might help to hold the population in check rather than to increase it. On the whole, then, the matter of the size of the population under collectivism is very largely one of conjecture.

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1. Why do collectivists think that the capitalistic type of economic system must be abandoned?
2. List the characteristics of collectivism in general.
3. On what grounds do collectivists condemn the capitalistic system of distribution?
4. What is meant by "the competitive wastes of capitalism"? Explain.
5. Are periodic business depressions inevitable under capitalism? Why or why not?
6. State briefly the nature of the major theories of Karl Marx.
7. Are these theories generally accepted today? Explain.
8. Distinguish briefly between socialism and communism.
9. Why do socialists and communists believe that land and capital should be owned by society?
10. How would land and capital be brought under social control?
11. What is meant by "the collective management of land and capital"?

12. How would the national income be distributed under socialism? Under communism? Explain.
13. Compare saving and capital formation under socialism or communism, with the same processes under capitalism.
14. To what extent would a socialistic economy make use of money and the price system? Why?
15. Why might a collectivist society have less need for a price system than a capitalist society?
16. Why is it claimed that collectivism would eliminate the competitive wastes of our present system?
17. Could collectivism reconcile individual and social interests? Explain.
18. Would business depressions occur under collectivism? Why?
19. Why would collectivists expect to have a full employment of labor under their system?
20. Would a system of collectivism result in the destruction of the family and of religious institutions? Why?
21. Why do many people think that society could not effectively control all economic activity? What is your opinion on this point?
22. How could a collectivistic economy select its leaders? Explain.
23. How are individuals induced to engage in economic activities under capitalism?
24. Could satisfactory incentives to efficiency be provided under collectivism? Explain.
25. Should collectivism be avoided because it would result in a loss of freedom for the individual? Explain.
26. Would the population problem bring about the downfall of a collectivistic economy? Why?

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25. *Socialism in Soviet Russia*

For twenty years, Soviet Russia has afforded an interesting and important example of a nation operating as a planned economy. So long as no country actually attempted to operate on a socialistic basis, discussions of the methods and possible achievements of a planned economy were highly theoretical. But Russia—or the Union of Soviet Socialist Republics, as it is now officially called—has provided a modern example of collectivism. With a land area of over 8,000,000 square miles and a population of 172,000,000 before World War II,[1] Russia has undertaken to substitute a socialistic economy for the capitalistic economy of her past. Hence, the Soviet economy is deserving of careful study.

Early Developments. Russia did not become a planned socialistic economy overnight. Soon after the capitalistic order was overturned by the revolution of 1917, an attempt was made to establish an economic system that would use none of the customary means of economic control. Money and prices were to be discarded. Consumers' desires were to be provided for through a system of rationing, and producers' needs by deliveries against special warrants. Nationalized factories were to furnish supplies of the various kinds of economic goods, while the Supreme Economic Council estimated the kinds and quantities to be produced. Industrial conscription was to be employed, to a considerable extent, to insure that workers performed the proper tasks. Russia had never achieved great success as an industrial nation even prior to World War I, and under this unprecedented and untried type of economic system economic activity fell off to a small fraction of even its pre-war level.

In 1921, a new economic policy was adopted which restored

[1] National Industrial Conference Board, *The Economic Almanac for 1945–46*, New York, 1945, pp. 2, 25.

money, prices, and buying and selling activities, and economic planning was attempted on a modest scale. Production revived gradually under this new policy, and by 1927 it had about reached its pre-war level. At this time, the first Five-Year Plan was drawn up, providing for a comprehensive program of economic planning. This Plan was announced as "completed" early in 1932, after a little more than four years of operation. The U.S.S.R. (as the Soviet Republics are commonly called) completed its second Five-Year Plan by 1937, and the third of these Plans was scheduled for completion in 1942, only to be rudely interrupted by the outbreak of the war with Germany in mid-1941. No new Five-Year Plan was attempted while World War II was in progress, but a fourth, to run from 1946 through 1950, was announced early in 1946. Before describing economic activity as it is carried on in the U.S.S.R., it will be necessary to examine briefly the present government of the country.

THE GOVERNMENT OF THE U.S.S.R.

The Communist Party. Any account of the government of the U.S.S.R. which failed to describe the nature and importance of the Communist party would be incomplete indeed, for the government and the party are one and indivisible. The Communist party, in other words, has outright control of political and economic life in the U.S.S.R. Though the party contains only about 5,000,000 regular and probationary members,[2] or something over 2 per cent of the population, and though non-Communists are allowed to vote and are sometimes elected to political office, most of the important economic and political positions in the country are, in fact, held by party members, and the party formulates all of the important policies which are carried out by the government. It is the only political party permitted to exist in Russia today.

New party members are drawn almost entirely from the various youth organizations of the party, which include about 17 million members according to one estimate.[2] These organizations are the Comsomol, or Young Communists, aged 15 to 26; the Young Pioneers, aged 11 to 15; and the Little Octobrists, aged 8 to 11. The party is highly organized, the organization progressing from factory,

[2] D. J. Dallin, *The Real Soviet Russia*, New Haven, Yale University Press, 1944, p. 214. It is only fair to say that estimates of membership in the Communist party and its youth organizations vary widely from one source to another.

farm, village, and city units, through district and regional congresses, to the All-Union Communist Party Congress. Control of the party is largely centered in its Central Executive Committee of 71 members and its Politburo of 14 members. Membership in the party is something of an achievement. A person is placed on probation for a period before being taken into regular membership, and the party has periodic "purges" which are intended to rid it of members who fail to live up to party standards. The party insists upon conformity to standards of personal conduct, as well as enthusiastic participation in party and civic activities, and enforces rigorous discipline within its ranks.

The Governmental Organization. The government of the U.S.S.R. operates on the basis of a constitution which was ratified late in 1936. The legislative powers of the government are exercised by the Supreme Council, composed of two houses, the Council of the Union and the Council of Nationalities, each having about 600 members. The Council of the Union is elected by the citizens, on the basis of one deputy, or representative, for every 300,000 citizens. The Council of Nationalities includes twenty-five deputies from each Union Republic, eleven from each Autonomous Republic, five from each Autonomous Province, and one from each National Region. All terms of office are four years in length, and the two legislative houses have equal rights. Laws are passed by a simple majority in each house, and each house elects a Chairman and two Vice-chairmen.

The Supreme Council selects the Presidium, which is really a committee of the legislative body. It is composed of a chairman, 11 vice-chairmen, and 24 other members. The Presidium has certain powers, such as the power to disband the Supreme Council in the event of permanent disagreement between the houses, to call new elections, to call the Supreme Council into session, and to exercise many of the legislative functions of the Supreme Council when that body is not in session. The highest executive or administrative organization of the U.S.S.R. is the Council of Ministers, which is selected by the Supreme Council and is responsible to it. The State Planning Commission, which is the chief agency for economic planning, is a Committee of the Council of Ministers. Justice is administered by the Supreme Court of the U.S.S.R., the Supreme Courts of the Republics and Autonomous Regions, and the People's Courts. The several Supreme Courts are selected by the Supreme Councils

of the U.S.S.R. and its constituent republics and regions, but the People's Courts are elected by direct vote of the citizens in the various districts. Every Union Republic and Autonomous Republic has a governmental setup almost identical with that of the U.S.S.R.

The government of the U.S.S.R. is federal in form, but power is concentrated largely in the central government. The central government controls all external affairs of the country, including a monopoly of foreign trade, and internally controls the planning of the national economy, approves the budgets of all governmental units, administers banks and all productive or business establishments which are of All-Union importance, administers transportation and communication, controls money and credit and the use of land, provides a single national system of accounting, controls education and public health, and establishes principles of labor legislation and of legislation governing the judicial system and procedure. In recent times, moves have been made in the direction of giving greater powers than formerly to the lower units of government, but it remains to be seen whether real or merely paper changes will be the result.

It is clear that, under the present government, the legislative, executive, and judicial powers of the government are exercised by separate organizations, though the legislature is superior to the other two departments of government in power and authority. Direct elections are substituted for the indirect elections which prevailed prior to 1936. Even members of the Supreme Council are elected directly, whereas the legislature in former times was several stages removed from the actual voters. Suffrage is universal for persons 18 years of age and over, with the exception of the insane and persons deprived of electoral rights by court sentence. All classes of voters have equal rights of representation in the legislative bodies, and elections are by secret ballot. However, there is still much economic rather than geographical representation, for this principle is fundamental to the Russian system.

Under the present constitution, equal rights are guaranteed to all citizens. All are granted freedom of speech, freedom of press, freedom of assembly and of holding mass meetings, freedom of street processions and demonstrations, and freedom of religious worship. Citizens are guaranteed inviolability with respect to their persons, homes, and correspondence. Going beyond the constitutional provisions of other countries, the Russian constitution guarantees the

citizens employment and payment for their work in accordance with its quantity and quality, the right to rest and leisure, the right to maintenance in old age, sickness, and accidents, and the right to education. Women have equal rights with men in all spheres of life.

The Dictatorship. In theory, then, the present Russian constitution and government appear most enlightened and democratic. In practice, the people of Soviet Russia live under a dictatorship, as they did before the present government was established. In theory any person, whether a member of the Communist party or not, may run for office. In practice, all candidates save one in each electoral district usually resign before an election is held, and the one remaining candidate is the fortunate individual who is approved by the Communist party. In the first election under the present constitution, more than 100,000,000 voters, or almost 97 per cent of those eligible, went to the polls, and all but 632,000 voted for the single candidates available in their districts. However, the Supreme Council elected in this manner contained 273 non-Communists. In the election of February, 1946, about 110,000,000 voters went to the polls and again showed startling unanimity in voting for the official candidates. The legislature usually votes unanimously for any party-sponsored projects which are placed before it.

Political crimes are regarded as the most heinous offenses that can be committed in Soviet Russia, and the dreaded secret police work day and night to ferret out persons suspected of political crimes and subversive activities. Prior to 1941, when he chose himself as Minister of Defense and Chairman of the Council of Ministers, the Russian dictator, Stalin, did not bother to hold any important official position in the government, but as General Secretary he ruled the Communist party which in turn controlled the government. In short, as someone has said, the people of Russia "have absolute power provided they do as they are told by the leader through the instrumentality of the party."

The Planning and Control of Industry

In considering the operation of Russia's economic life, we must bear in mind that Russia is under a socialistic system. That is to say, land and capital are socialized and are owned by society, the former entirely and the latter largely. Therefore, it falls to the lot of society, working through the established agencies of government, to plan

and direct the use of these basic means of production. In noting how these plans are made and carried out, we shall consider agriculture separately, for the arrangements in agriculture are quite different from those in manufacture.

Industrial Organization. Though there are some differences as between industries in the field of manufacture, the general outlines of industrial organization are quite clear. The individual enterprises or factories, operated by governmental units or cooperative organizations, are formed into trusts or combinations, sometimes one trust to an industry but usually several. The trusts exercise a considerable measure of control over the factories, and for some purposes the trust, rather than the factory, is the industrial unit. For example, the trust controls raw material supplies for its factories and markets their output. The price paid for such output is determined for the trust as a whole, rather than for individual factories. The trust also appoints managers for the individual plants, approves wage contracts, and requires the plants to use the most efficient methods available, interchange technological experiences, standardize their products, keep accounts and stocks of goods properly, and make full use of their resources.

Over the individual plants and trusts in an industry, a higher organization called an administration is found in some cases. This agency supervises the work of the subsidiary organizations and sees to it that the industry as a whole carries out its part in the general economic plan. Subject to the main economic plan, each administration supervises and controls the construction of new productive facilities, the use of the profits made by the trusts, and the accounting methods used by the lower organizations, besides appointing boards of directors for the trusts, engaging in research work, training personnel, and levying fines and penalties on the lower organizations. In such cases, several industries and their administrations are grouped under a Ministry, or department of government and economic activity, headed by a member of the Council of Ministers which we mentioned previously as the highest administrative agency of the government. In other cases, the individual plants and trusts in an industry are responsible to Departments, and these agencies in turn to a Ministry which, in these cases, has charge of just one industry instead of a group of industries.

The Method of Planning. The general objectives to be undertaken by the economic system are planned by the Congress of the

Communist party for several years at a time. Within the general outline of such objectives, Five-Year Plans (and subsidiary annual plans within the Five-Year Plans) must be drawn up in detail for the economy as a whole, and for each organization or unit within the system. When a new Five-Year Plan is to be constructed, the State Planning Commission, a subsidiary of the Council of Ministers, draws up a first draft on the basis of a mass of statistical evidence gathered for the Commission by several other agencies. The Plan is then broken up into parts, which are handed over to various subsidiary planning agencies connected with such functional units as Ministries, administrations, trusts, and factories, on the one hand, and such geographical units as republics, provinces, regions, and communities, on the other.

The parts of the Plan are examined at each of these various functional and geographical levels, and criticisms, suggestions, and counter-proposals are offered, ostensibly for the guidance of the State Planning Commission. The parts of the Plan, together with the proposed changes, are reassembled in the hands of the Commission, which makes the final draft of the Five-Year Plan. After the final draft is approved by the officials of the Communist party and the Supreme Council, it is again divided up, and appropriate sections are sent back to the various functional and geographical units, so that each may know exactly what is expected of it for that period.

Since the State Planning Commission is composed of a President, a Board of eleven members, and a Council of about seventy persons selected from among the noted scientists, engineers, economists, and cultural leaders of the economy, and since it has a staff of several thousand technicians, statisticians, and clerks, it is probable that the Commission itself does virtually all the planning under the Russian system. The complicated procedure used in formulating the Plans probably exists for the purpose of creating enthusiasm for planning, giving many citizens a feeling that they are participating in the management and direction of the economy, and occasionally getting various factories or trusts to undertake greater productive feats than the Commission would have required of them. The Plans themselves are very bulky documents. The first Five-Year Plan totaled some 1600 finely printed pages, and the second totaled 1300 pages.

Under the Russian planned economy, the activities of every industrial unit are obviously quite closely circumscribed. A plant is

given a specified output to achieve, or to exceed if possible; it is told the amount and kinds of labor it may have and the wages to pay, the amount of working capital which it is granted or may borrow, what is to be done with this capital, the amounts of materials and supplies it may have and at what prices, and the agency to which it is to sell its output and at what price. It is clear that the Plans are both physical and financial in character. From the physical point of view, they are a matter of so many units of output, so many workers of various kinds, and so much land and capital. From the financial point of view, both selling prices and costs of production are predetermined for the several industrial units.

It is something of a problem to set prices at which goods are to be sold to the governmental agencies which then proceed to distribute them to consumers. If the government should set any one price for all concerns making certain products, some concerns could make profits without striving greatly for efficiency, while others would be unable to cover costs no matter how hard they tried. On the other hand, to specify different prices for identical goods produced in different factories would lead to many complications. The problem has been solved by having every trust take over the output of its individual factories and sell it at one price established by a price-fixing commission. This price is supposed to be sufficient to cover the planned costs of the subsidiary factories as a whole and the costs of running the trust, and to provide also for the payment of the "turnover" tax from which the government derives a large part of its revenue. The trust then computes what part of the price must be turned over to the individual factories to cover the money costs which they must meet, and the remainder is retained by the trust itself.

The Relation of Prices and Costs. We see, therefore, that money is used in the U.S.S.R., and prices and costs are expressed in terms of money, but the relationship between prices and costs in a capitalistic order like the United States of America is very different from their relationship in Russia. The prices that Russian productive establishments are allowed to charge are usually supposed to cover costs and yield a profit, given normal efficiency on the part of the productive units; but these prices are not necessarily the same as those charged to consumers. In some cases, the prices charged consumers are less than those received by the industries, so that the government is, in effect, subsidizing these particular industries. In

other cases the reverse is true, and the government reaps a profit on its sale of certain goods to consumers. Of course, when profits are made under the Russian system, they do not go to private individuals as in this country.

Another important point is that the relationship between costs and prices does not control production in the U.S.S.R. In our system, if the price at which a good can be sold to consumers is for a long time too low to cover costs of production, the quantity produced will be restricted; and the receipt of prices which are more than enough to cover costs of production will have the opposite effect. In Russia, however, production is controlled by the government and it may be decided to increase production in a non-profitable industry or to decrease it in a profitable industry, if such measures appear to be desirable from the point of view of public welfare. Prices and costs are used merely as accounting devices in Russia. They furnish a convenient medium for expressing the content of plans for different industries, and for comparing the results achieved. Since each productive establishment has its costs and prices determined for it, it makes or does not make unplanned profits according to the efficiency with which it operates. A lack of profit in a particular year may mean little or nothing with regard to efficiency, but long-continued losses by a productive establishment are at least *prima-facie* evidence of faulty operation. Such losses might lead to a reorganization of an establishment or to a change in management, but the fact of a profit or loss plays little part in influencing decisions of the government as to what goods shall be made or the quantities in which they shall be made.

The Problem of Planned Production. In our own system, consumers express the relative strength of their desires for different economic goods through their willingness to pay high or low money prices, and producers presumably are guided by these prices into producing the goods most desired by consumers. But in Russia the government, through the State Planning Commission, decides what shall be produced and in what quantities; and the important question is how well production can be adjusted to meet the desires of the people as consumers under this system. In part, this coordination depends upon the temper of the planning authorities. If they decide to devote the productive resources of the country to building up a huge war machine or to supplying the country with large amounts of capital goods immediately, consumers' wants may go

largely unsatisfied for a time. However, if the authorities undertake to adapt production to consumers' desires, a very considerable degree of success may be achieved. Up to the present time, it has been relatively easy to dispose of the things which were produced, because the Russian people were so desperately in need of all kinds of goods when planned production was started. Later on, when basic wants are more nearly satisfied, the problem of adjusting production to human desires may become a more serious one. However, it should be emphasized that, if maladjusted production should come about, it would not lead to a breakdown of the system. For the government controls prices and can always get rid of goods by lowering prices sufficiently or discourage their purchase by raising prices; and eventually, of course, it may be possible to adjust production so that it will be closely related to consumers' desires.

The planning authorities can measure the success of their production policies in satisfying human desires by observing the alacrity or reluctance with which consumers take economic goods off the market. In the past, however, such information was not completely reliable, for the Russian government rationed certain commodities among the consumers at artificially low prices. Under these conditions, neither the demand for rationed commodities nor that for non-rationed commodities gave an accurate picture of consumers' desires. Since people were allowed to buy only certain quantities of the rationed commodities, it was impossible to decide how much more of their incomes they would have spent on these goods had they been permitted to do so. On the other hand, their purchases of non-rationed goods may have been much greater, *because some commodities were rationed,* than they would have been if the people had been free to spend their incomes as they desired. After the rationing of consumers' goods in the U.S.S.R. had been discontinued, the reactions of consumers to planned production at planned prices became a safer guide for the planning authorities than formerly.

Some hope for success in the adjustment of planned production to human desires arises from the fact that the planning authorities in Russia are able to avoid some of the pitfalls of capitalistic systems. Without any great effort, the authorities decide that luxurious yachts and limousines shall not be built so long as the people have unsatisfied wants for food and clothing. It is similarly easy to decide that

worthless patent medicines and other harmful goods shall not be made while the people lack adequate housing. It is possible to standardize the products turned out, instead of permitting the production of many competing varieties, and, of course, productive resources are not wasted in creating competitive advertising designed to lure customers from one brand of a product to another or even from one product to another. Finally, having decided the volume of output to be achieved in each industry, the planning authorities can see to it that the productive facilities of the industry are only sufficient to insure this output. The output decided upon may or may not be the proper quantity from the point of view of consumers, but in any case it is possible to provide for the amount planned without the wasteful duplication of productive facilities, which is characteristic of competitive economic systems.

AGRICULTURE IN THE U.S.S.R.

Agriculture in the U.S.S.R. is planned in much the same way as manufacturing, but the government does not operate agricultural establishments to the same extent as industrial establishments. The government owns farm land as it owns other kinds of land, but it actually directs only a relatively small part of agricultural production. For the most part, reliance is still placed in individual initiative and the incentive of pecuniary rewards to induce the farmers to produce in abundance.

The State Farms. Soviet Russian agriculture is organized in three forms. First, there are state farms. These are operated directly by the government through agricultural trusts, and their organization is sufficiently similar to that of the manufacturing industries to make a detailed description unnecessary. The total output of these farms must be turned over to the appropriate governmental agency at specified prices, and the farm workers are paid wages. When the state farms were first set up, the emphasis was on great size. The minimum size was about 5000 acres, and some farms, in grain production, "embraced hundreds of thousands of acres, with huge fleets of combines, batteries of searchlights for night work, radios sending orders to the harvesters encamped for weeks in the distant fields, and airplanes bringing their medicines, magazines, and entertainers."[3]

[3] A. R. Williams, *The Soviets*, New York, Harcourt, Brace & Company, Inc., 1937, p. 173.

Since the state farms, under the first Five-Year Plan (1928–32), increased rapidly in number and in the proportion of the total cultivated area which they controlled, it was widely assumed that a gradual shift of agricultural activity from other types of farms to state farms was desired by the government. However, the large state farms were inefficient, as was indicated by poor crops, a heavy mortality rate for livestock, frequent changes in officials, and high labor turnover. As a result, some state farms have been broken up into smaller collective units, and the percentage of the total cultivated area controlled by the state farms declined from 12.1 in 1936 to 8.9 shortly before World War II.[4] This may mean that Russia intends to depend permanently on collective or cooperative farms for most of her agricultural production.

The Collective Farms. Collective farms are the most important type of farm organization in the U.S.S.R. They vary in size from a dozen to more than a thousand peasant households each. The average collective farm contains about 130 peasant families and 1228 acres of land.[5] Under the usual form of organization, the peasant retains his dwelling, livestock for purely domestic use, household goods, and a little land for a garden; but the rest of the land, buildings, machines, tools, and livestock are used collectively. These collective units do not, as a rule, own many large agricultural implements, such as tractors or combines, but receive the services of such equipment from machine-tractor stations, of which there were some 6350 scattered over the country at the beginning of World War II.[6]

The peasants work in common, performing planned and assigned tasks under group leaders. Their incomes depend upon a number of factors. In many cases, a portion of the crop must be set aside for use as food or fodder. Deductions are made to pay taxes to the government, interest or principal on loans which the farm may have received from the government, and rent for the use of farm machinery borrowed from machine-tractor stations. The rest of the crop is sold to the appropriate governmental agency, and the money received is distributed among the collective farmers. The work of the farmers is divided into seven categories, with the lowest getting

[4] M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, New York, The Macmillan Company, 1939, p. 199.

[5] E. Snow, *People on Our Side*, New York, Random House, 1944, p. 107.

[6] M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, p. 205.

one-half labor day's credit, and the highest two labor days' credit, for each day's work. Each farmer gets a share of the farm income on the basis of the number of days worked and the category into which his type of labor falls.

Since the government does not operate the collective farms, it is necessary to employ devices to insure that the collective farmers will raise the desired types of products in appropriate quantities, since otherwise the plan for the whole economy might be seriously disrupted. Such devices lie ready to hand in the Russian system. Collective farmers are induced to raise the planned crops by being granted low taxes, low interest rates or outright grants of funds, low charges for machine-tractor service, and high prices for the portion of crops that is available for sale. Collective farmers who raise the "wrong" crops may be penalized by high taxes; high interest rates, repayable loans, or even denials of credit; high charges for machine-tractor service, or even an artificial "shortage" of such service; and low prices for the remainders of their crops. Thus, the operations of the collective farmers are controlled by working on the economic motivation of the farmers.

The number and importance of the collective farms have been increasing by leaps and bounds. Under the first Five-Year Plan, their number increased from 33,300 to 211,100, and their cultivated area from 2,517,000 hectares to 94,038,000 hectares, or from 2.2 per cent of the total cultivated area of the country to 70 per cent. By 1937, there were 243,700 collective farms, cultivating 121,001,000 hectares, or 89.4 per cent of the total cultivated area.[7] The status of the collective farms then remained constant until the beginning of the war with Germany.

Peasant Farms. Finally, some agricultural land is still cultivated by about 3,000,000 individual peasants. They do not, of course, own the land, but they support themselves by working it and selling their surplus products. Like the collective farmers, they must sell a certain percentage of their output to the government at low fixed prices (as a tax), and in general they are treated somewhat more harshly in this respect than the collective farmers, in order to discourage the individual type of farming. In 1928, individual peasants

[7] Birmingham University, Bureau of Research on Russian Economic Conditions, *Results of the Second Five-Year Plan and the Project of the Third Five-Year Plan*, Birmingham, England, 1939, p. 8.

operated almost all of the cultivated area of Russia, but their holdings declined to less than one per cent of the total by the beginning of World War II.

The Distribution of Income

Land and Capital. Since land in the U.S.S.R. is owned by society as a whole, private individuals do not receive rent. Land is apportioned among industries in accordance with the plans for economic activity. The industries are not charged rent for the use of the land, though certain taxes (such as those imposed upon farmers by requiring them to sell a part of their crops to the government at specified low prices) might be construed as rents. Again, the funds which are available for capital investment are apportioned among the industries by several government banks. Here, too, there is no consideration of the possible earnings of capital in different uses, or of the rates of interest which industries might be willing to pay. The assignment of capital funds (and the interest, if any, that is charged) depends wholly upon plans which have been made in the light of the need for expanding productive facilities in the several industries.

With respect to the volume of new capital, as distinguished from the rationing of existing capital, the situation is a little more complex. In a physical sense, the process of saving and capital formation is carried on collectively. That is, the Planning Commission decides that, in the next five years, say 50 per cent of the national income should take the form of new capital goods instead of new consumers' goods and services. It plans accordingly, and sees to it that the plans are carried out. The cost of saving and capital formation is the same in Russia as elsewhere. That is, the cost of augmenting the supply of producers' goods, or capital, which will make for a more abundant life in the future, is the necessity of accepting for the present a smaller real income in the form of consumers' goods; for, in directing resources into the construction of capital goods, the productive factors available for turning out consumers' goods are diminished for the time being. In capitalistic countries, the relative amounts of capital formation and present consumption are determined by individuals, influenced by interest rates and the prices of consumers' goods, while in Russia the decision is made by the Planning Commission without any necessary regard for the desires of

consumers. If the government goes in so extensively for capital construction that immediate income in the form of consumers' goods is unduly diminished, the people have to adjust themselves to the situation.

In regulating saving and capital formation, the Planning Commission may adopt either of two plans. The first is to see to it that, in a given year, the people receive money incomes just large enough to take the available consumers' goods and services off the market. The second plan is to give the people of the country a total money income equal to the value of the entire national real income, and then recapture sufficient of the money income so that what remains just buys the available consumers' goods and services. Strangely enough, the second method is used in Russia.

The measures used to recapture a part of the money incomes are various. Attempts are made to induce the citizens to save, and to invest their savings in government bonds or savings accounts. The products of some industries are sold at prices somewhat higher than planned costs, so that planned profits are made. A turnover tax, similar to a sales tax, is collected on many products. The rate of this tax is as high as 90 per cent on individual products, and in some periods has amounted altogether to some 60 per cent of the total receipts from retail trade.[8] Other taxes are levied as well, and individuals are required to contribute to funds for social security and other purposes. In the end, the consumers are presumably left with enough money income to buy the available consumers' goods and services, but no more.

The Apportionment of Labor. Since rent and profits do not accrue to individuals in Russia, and since the amount of interest received by private individuals is negligible, it follows that the national income available for consumption is distributed in the form of wages. The apportionment of labor among industries and occupations, and the determination of the wages to be paid for different types of labor, have given some trouble to those in authority. Since land and capital are not human agents of production, and have no feelings or home ties, they may safely be assigned in arbitrary fashion to various industries and parts of the country in accordance with the plan. But the case of labor is different. It would be inhumane, and probably uneconomical as well, to assign labor in a purely

[8] M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, p. 164.

arbitrary fashion. On the other hand, the workers cannot be depended upon to move spontaneously to the positions in which they are most needed and can be of greatest service to society.

In this dilemma, the government has had recourse, for the most part, to the capitalistic method of rationing the labor supply. High wages or superior rations at government stores have been used to attract workers to industries and posts where more labor is needed, and low wages or inferior rations to get them away from occupations where less labor is required. Because of preferences, habits, and prejudices on the part of the workers, these inducements do not work perfectly in apportioning the labor supply in Russia; but neither do they work perfectly in capitalistic countries. In general, the freedom of movement of Russian workers has been so extensive that it has resulted in high labor turnover and much absenteeism.

Differential Wages. Even the best economic plan is of little use unless it is efficiently carried out. To encourage efficiency, it has been found necessary in Russia to reward good work with relatively high wages. Wage differentials have been used, also, in the hope of getting people to accept difficult and responsible positions requiring considerable ability and training. But the distribution of national income according to the productivity of labor is quite a different thing from equal distribution, or distribution on the basis of needs. Moreover, wage differentials based upon productiveness are especially embarrassing to the Communists of Russia, who have held that common labor is as honorable an occupation as any, and is entitled to as high a wage. However, embarrassing or not, it has been necessary to make this concession to capitalistic methods.

But it may be said that wage differences in Russia are small as compared with differences in money income in capitalistic societies. By the end of the first Five-Year Plan, the ratio between the highest and lowest money wages was commonly reported to be about 10 to 1. This ratio was reported to be about 12 to 1 in 1937.[9] A decree of November, 1937, established a minimum wage of 110 rubles per month for workers in industry and transportation, and a further decree of August, 1938, prohibited salaries above 2000 rubles per month.[10] On this basis, the extent of inequality in incomes for workers of all grades in industry and transportation was about 18 to 1. Inequality over the whole economy was somewhat greater than this,

[9] *The Nation,* November 13, 1937, pp. 523–526.

[10] M. T. Florinsky, *Toward an Understanding of the U.S.S.R.,* p. 168.

for some workers in other fields undoubtedly received wages which were below the minimum established for workers in industry and transportation. Finally, a recent estimate has it that the extent of inequality in income distribution in Russia, as measured by the highest and lowest wages, is about 20 to 1.[11] A degree of inequality indicated by the ratio of 20 to 1 is, of course, extremely slight in comparison with inequalities in capitalistic countries, where the ratio between the highest and lowest incomes is several thousand to one (some socialists say 40,000 to 1 in the United States and Great Britain).

Critics of the Russian economy sometimes allege that these admitted differences in wages and incomes do not tell the whole story, and that high party and industrial officials draw salaries which are far above the legal maximum. Sometimes, the critics say, these fortunate individuals receive as much as 7000 rubles a month. On the basis of the minimum wage for workers in industry and transportation, this would produce an inequality of about 64 to 1 between the highest and lowest incomes. In any case, money wages do not tell the whole story, for all Russian workers receive some real income directly from the government without charge. If such free services were distributed more unequally than the money wages, they would make for increasing inequalities in real income, but the chances are that these services do not vary greatly in amount as between individuals. If this is the case, their distribution tends to reduce inequality in terms of real income.

In the past there was another reason why differences in money wages in Russia did not mean corresponding differences in real wages. Under the old system of distributing consumers' goods, a man with a money income ten times as great as that of another might have had a real income only (say) twice as great. For both men were probably allowed to purchase the same quantities of rationed goods *at low prices*, but the one with the larger money income had to spend the balance of it in the open market at prices many times as high as those of rationed commodities. Hence, his advantage in terms of real income was relatively small. Indeed, workers receiving low money wages were sometimes definitely favored in the matter of rationing.

The differences in real wages in Russia have in general been so

[11] A. Yugow, *Russia's Economic Front for War and Peace*, New York, Harper & Brothers, 1942, p. 165.

small in the past that many people questioned that they would result in efficiency or even the voluntary acceptance of the more difficult and responsible positions. This problem of providing incentives under the relatively equal income distribution of a planned economy was discussed in the preceding chapter, and need not be enlarged upon here. At any rate, Russia does not depend entirely upon financial or economic incentives in her control of the labor supply. If worst comes to worst, the government has the power to draft or conscript labor to serve in any and all industries, and severe punishments may be imposed for inefficiency. The members of the Communist party and the Russian Army are also available as an emergency labor force which may be arbitrarily assigned to any type of work anywhere, and the Young Communists are subject to virtually the same regulation. When workers have been placed to the satisfaction of the authorities, there have been devices available to keep them there. These devices have included keeping the workers in arrears in their pay, and issuing ration cards through the factory so that a worker has had to surrender his ration card if he has given up his job.

The Marketing of Consumers' Goods

Until quite recent times, the process of getting economic goods into the hands of final consumers was very complicated in Soviet Russia. At the beginning of the first Five-Year Plan, some stores were operated directly by the government, others were run by cooperative associations, and still others by private individuals. The private traders were virtually eliminated by 1933, and the business was about equally divided between cooperative and government stores. Since that time, the government stores have become more and more important, and have taken over all of the business in the cities. In 1937 the government stores controlled approximately two-thirds of the retail trade.

Rationed and Unrationed Commodities. In the early years of economic planning, there were several types of "closed" stores in the Russian merchandising system. In one type, only the workers in particular enterprises could buy at low prices, on the basis of ration cards. This arrangement provided a means of favoring important groups of workers. In a second type of closed store, all citizens possessing ration cards could purchase definite physical quantities of specified goods. Their prices were higher than those of the stores

operated for the benefit of the workers of particular enterprises, but lower than those in the "open" stores in which anyone could buy as much of any available commodity as his purchasing power would permit. Finally, there were special stores (Torgsin and Isnab) at which foreigners traveling or employed in Russia could make purchases.

The use of ration cards did not always indicate extreme scarcity of the rationed goods. It merely meant that these goods were being sold in the closed stores at prices which were very low in view of their limited quantities. The goods could have been distributed just as effectively without rationing, by allowing their prices to rise to any level to which the competitive bids of buyers might force them. But these high prices would have resulted in persons with relatively large money incomes getting all the goods, while less fortunate persons were excluded from the market altogether. By rationing at low prices it was insured that most persons, regardless of the size of their incomes, would be able to buy small amounts of these commodities. The rationing method constituted a severe restriction on consumers' freedom of choice, for ration cards were honored only in terms of the rationed commodities, while the possession of money income, without rationing, would permit the individual to buy whatever he chose. However, this restriction of choice was probably not a serious matter, so long as rationing was confined to the necessities of life.

Changes in Marketing. The rationing of bread and flour ended in 1934, and that of other commodities in 1935. Thereafter, anyone could buy as much goods as he wished in any shop, within the limits of his purchasing power. The retail prices of goods were not uniform throughout the country, but they were the same in all stores within each of several zones or districts. Rationing came to an end as the result of increased production of consumers' goods, the diminution of the need to favor special groups or classes of persons, the superior effectiveness of wage differentials (as compared with differential rations) in distributing the labor supply among industries and places, and the desire to improve the methods of retailing, which did not need to be very well managed so long as people purchased on the basis of rations. The changes, of course, were for the better, though the merchandising system was still under close governmental control. The government ownership and operation of the basic means of production, combined with

considerable freedom of choice on the part of the citizens as to what they will consume, come close to the ideal of a socialistic society.

The Resumption of Rationing. The new unrationed system of retailing was continued only until July, 1941, soon after the beginning of the war with Germany. At that time it became necessary to reintroduce rationing in the case of bread, butter, meat, sugar, shoes, clothing, tobacco, and a number of other goods. Some of the wartime rations, such as those of meat, fish, and macaroni, were considerably more generous than those which prevailed in the earlier rationing period; but others, such as those of sugar and bread, were almost identical with the rations of the earlier period. As in the earlier rationing period, the citizens were divided into several classes for rationing purposes, and considerable differences in rations existed as between these groups.

International Trade and Money

The Trade Monopoly. While Russia has many and varied productive resources and is, at least potentially, more nearly self-sufficient than most economies, she has had at times to depend upon foreign countries for supplies of several kinds. Moreover, she has tried to make sure that importing and exporting will be carried on only when her interests require them, for the international trade of the country is carried on as a governmental monopoly. The government has also monopolized international financial operations, conducting them in the past in terms of an artificial monetary unit which was not used domestically. When a quantity of a foreign product is essential to the operation of the plan, the trading monopoly is in a strong position, for it can sell Russian products abroad at almost any prices in order to obtain purchasing power in other countries. It could, for example, sell wheat abroad at a price only half as high as that which the government paid the farmers, and the government would make up the loss incurred in this way by selling other articles in the domestic market at a profit.

However, the trading monopoly has to be careful about dumping goods abroad, lest other countries refuse on this account to trade with Russia; and, of course, it cannot command higher prices in the world market than the exporters of other countries are getting. Any sharp fall in the world price of a good which Russia is exporting

means that a larger quantity than usual of the good must be sent from Russia to get a given amount of purchasing power abroad. This means, in turn, taking more goods than usual away from the Russian consumers. It is quite clear, then, that in Russia the costs of importation lie in the amounts of exports which must be given up in exchange and hence subtracted from domestic consumption.

Control of the Money Supply. The issuance of money in Russia, while theoretically limited by requirements for the maintenance of gold or other reserves, is in reality entirely under the control of the government. Moreover, since the government has maintained a monopoly in international trading and in international financial operations, using an artificial monetary unit, the management of the domestic monetary supply has been freed from the influence of such things as international gold movements, interest rates at home and abroad, the international balance of payments, and fluctuations in foreign exchange rates, which are of importance to capitalistic countries under normal conditions. Nothing that happens in the international field can force Russia into inflation or deflation at home, or cause her to expand or contract her currency and credit.

It appears, then, that the monetary problem is primarily one of adjusting the supply of money to domestic needs. That is, the government must be sure that the citizens receive enough purchasing power to enable them to remove from the market the available quantities of goods at the prices at which these goods are offered. However, the overissue of currency would matter relatively little. Since the government controls prices rigidly, the issuance of excessive amounts of currency could not raise prices, but instead would only increase the unspent surpluses in the pockets of consumers. The use of money involves the use of money prices and, as we have seen, the Russian economy is quite experienced in pricing goods in terms of money. However, it will be recalled that price movements are not so influential in Russia as elsewhere. In distributing consumers' goods among the citizens and in apportioning the supply of labor among industries and occupations, price movements operate to some extent in Russia as in other countries. But they have little, if any, influence on the distribution of land and capital among industries, on the total volume of saving and investment, and on the determination of the kinds and quantities of economic goods to be produced.

Accomplishments of Russian Economic Planning Prior to 1941

General Results. The Soviet planned economy, at the beginning of Russia's war with Germany, was still too young to permit observers to reach any complete or final appraisal of its accomplishments and failures, but certain tentative observations may be made on the basis of the only available type of information—the official statistics published by the Soviet government itself. The fact that Russia was able to keep a planned economy functioning might almost be listed as an accomplishment, since many people doubted the possibility of such an achievement before the Russian experiment actually began. However, official statistics indicate not only continued operation but rapid progress in many respects. For example, the Russian national income, which had amounted to some 21 billion rubles in 1913, and to 25 billion in 1928, increased to over 45 billion in 1932 (after the first Five-Year Plan), to 96 billion in 1937 (after the second Five-Year Plan), and to 125.5 billion in 1940. The third Five-Year Plan called for a further increase to approximately 173 billion rubles by 1942.[12]

Another accomplishment is found in the extremely rapid industrialization of Russia under the planned economy. The capital investment in industry amounted to 52½ billion rubles under the first Five-Year Plan, and to 115 billion under the second Five-Year Plan. It was expected to reach 180 billion rubles under the third Five-Year Plan, and had reached 108 billion by the end of 1940.[13] The number of workers in large-scale industry increased from 3,000,000 in 1913 (and 1928) to 6.4 millions in 1932, and 7.7 millions in 1936. It was expected to reach 9.3 millions by 1942.[14] The total number of workers in state enterprises was 27 millions in 1937 and 30.4 millions in 1940, which may be compared with the total of 11.4 million wage earners in 1913.[15] Russian industrial production was 3.8 per

[12] H. Johnson, *The Soviet Power*, New York, International Publishers, 1940, p. 194, and N. Vosnesensky, *Economic Results of the U S.S.R. in 1940 and the Plan of National Economic Development for 1941*, Moscow, Foreign Language Publishing House, 1941, p. 10.

[13] M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, p. 164; and N. Vosnesensky, *Economic Results of the U.S.S.R. in 1940 and the Plan of National Economic Development for 1941*, p. 9.

[14] *Results of the Second Five-Year Plan and the Project of the Third Five-Year Plan*, p. 5; and H. Johnson, *The Soviet Power*, pp. 347–349.

[15] N. Vosnesensky, *Economic Results of the U.S.S.R. in 1940 and the Plan of National Economic Development for 1941*, p. 32.

cent of world industrial production in 1929, but 11.0 per cent in 1932, and 15.2 per cent in 1936. It was expected to reach 32.0 per cent in 1942.[16] The average wage per industrial worker was 870 rubles a year in 1928, 1478 rubles in 1942, 3447 rubles in 1937, and 4069 rubles in 1940. The planned average wage for 1942 was 4722 rubles.[17]

Rapid progress was also made in the socialization or collectivization of the Russian economy. In 1928, almost all of the agricultural resources of the country were still in private hands, but by 1937, 98.6 per cent of all agricultural production was carried on by state or collective farms. By 1937, 98.7 per cent of all the non-human means of production in the system had been brought into socialized ownership, 99.8 per cent of industrial production was in the hands of state enterprises, and virtually 100 per cent of the internal commerce of the country was carried on by state or collective enterprises.[18]

Results in Terms of Specific Commodities. In Table 26 we present statistics of the production of several important industrial and agricultural commodities in Soviet Russia in the years 1913, 1928, 1932, 1937, and 1940, together with the planned estimates of production for 1932, 1937, and 1942. It may be noted that the production of most of these commodities had been increased very greatly by 1937, as compared with 1913 and 1928, and that still greater accomplishments were planned for 1942. In some cases, production had exceeded the planned estimates, in others it had fallen a little short, and in still others it had missed the estimates by a wide margin. On the whole, however, the only reasonable comment on these statistics seems to be that they are remarkable, if accurate.

The Elimination of Depressions. Supporters of the Soviet régime are fond of referring to the U.S.S.R. as "the land without depressions," and in general its claim to this title seems to have some justification—although some critics are so unkind as to say that the apparent absence of cyclical fluctuations in Russia indicates merely that the country is in a state of perpetual depression. But whatever the level of economic activity may have been in Russia, it seems

[16] H. Johnson, *The Soviet Power*, pp. 92, 93.

[17] *Handbook of the Soviet Union*, New York, The American-Russian Chamber of Commerce, 1936, pp. 69–70; H. Johnson, *The Soviet Power*, pp. 69, 347–349; and N. Vosnesensky, *Economic Results of the U.S.S.R. in 1940 and the Plan of National Economic Development for 1941*, pp. 10, 32.

[18] M. T. Florinsky, *Toward an Understanding of the U.S.S.R.*, p. 173.

TABLE 26. PRODUCTION OF IMPORTANT INDUSTRIAL AND AGRICULTURAL COMMODITIES IN SOVIET RUSSIA IN SELECTED YEARS IN COMPARISON WITH PLANNED ESTIMATES [a]

Item	Units	1913	1928	1932 (actual)	1932 (planned)	1937 (actual)	1937 (planned)	1940 (actual)	1942 (planned)
1. Locomotives	Numbers	418	478	828	1600	1581	2800	1600[b]	2340
2. Goods trucks	Thousands	14.8	10.6	20.2	12.6	66.1	118.4	51.0	120.0
3. Motor cars	Thousands	0.1	0.7	23.9	105.0	200.0	200 0	194.9[b]	400 0
4. Tractors	Thousands	...	1.2	50.6	55.0	80.3	88.5	..	.
5. Electric power	Billions of K.W.	1.9	5.0	13.5	22.0	36.4	38.0	40.1[b]	75.0
6. Oil	Million tons	9.2	11.7	22.3	21.7	30.5	46.8	34.2	54.0
7. Coal	Million tons	29.1	35.5	64 7	75 0	127.9	152.5	164.7	243.0
8. Pig iron	Million tons	4.2	3.3	6.2	10.0	14.5	16.0	14.9	22.0
9. Steel	Million tons	4.2	4.3	5.9	10.4	17.7	17.0	18.4	27.5
10. Rolled steel	Million tons	3.6	3.4	4.3	8.0	13.0	13.0	13.0	21.0
11. Sulphuric acid	Million tons	157	211	552	1450	1666	2080	...	.
12. Cement	Million tons	1.5	1.8	3.5	6.4	5.5	7.5	5.3	11.0
13. Sawn lumber and timber	Million cubic meters	11.9	13.6	24 4	42.5	33.8	43.0	..	45.0
14. Paper	Thousand tons	205	284	479	900	832	1000	.	1500
15. Cotton textiles	Million meters	2227	2742	2417	4700	3447	5100	3800	4900
16. Woolen textiles	Million meters	95	93.2	88.7	270.0	108.3	220.0	123.0[b]	177.0
17. Leather shoes	Million pairs	8.3	29.6	84.7	84.0	164.2	180 0	148 3[b]	258.0
18. Raw sugar	Thousand tons	1290	1283	1403	1400	2421	2500	162 2	3500
19. Grains	Million metric quintals	816	733.2	698.7	1057 8	1202.9	1048.0	1190.0	1300.0
20. Cotton	Million metric quintals	7.4	8.2	12.7	19.1	25.8	21.2	25.2	32 9
21. Flax	Million metric quintals	3.3	3.2	5.0	6.2	5.7	8.0	6.7	8 5
22. Sugar beets	Million metric quintals	109.0	101.4	65.6	195.5	218.6	276.0	.	282.0
23. Horses	Million head on hand	35.8	33.5	19.6	36.9	16.7	21.8	..	21.9
24. Large-horned cattle	Million head on hand	60.6	70.5	40.7	80 9	57.0	65.5		79.8
25. Sheep and goats	Million head on hand	121.2	146.7	52.1	160.9	81.3	96 0		170.7
26. Pigs	Million head on hand	20.9	26.0	11.6	34.8	22 8	43.4		45.6

[a] Source: *Results of the Second Five-Year Plan and the Project of the Third Five-Year Plan*, pp. 5, 13; and several minor sources.
[b] 1939 production.

clear that this activity has not thus far been characterized by any of the business breakdowns which occur at frequent intervals in capitalistic countries.

This does not mean that instability of economic activity is impossible in Russia, and that business depressions or breakdowns could not occur there under any circumstances. It does mean, however, that if the Soviet system is well managed and if the desire to eliminate business depressions is sufficiently strong, Russia is in an advantageous position for maintaining economic stability. She is in a position, as we have seen, to avoid many of the types of waste which ordinarily characterize capitalistic states. Production is planned and controlled by society as a whole through governmental agencies and is not dependent, as in capitalistic countries, upon the decisions of thousands of independent and uncoordinated individuals. As a result, misdirected production should be less likely to occur in Russia than elsewhere. Of course, the planning authorities have to plan production for future markets, and it is likely that mistakes will be made in estimating consumers' needs or demands. However, since they are in a position to control prices as well as other economic matters, it will be possible to prevent such mistakes from clogging the markets with unsalable commodities, especially since it is not necessary in Russia for any particular commodities to sell at profitable or cost-covering prices.

Finally, the conflict between individual and social interests has been minimized in Russia. Economic activity is carried on in the interests of society as a whole, and its object is to produce goods in abundance rather than at a profit. In other words, there are no private enterprisers in Russian industry whose doubts and fears might at times lead them to restrict production, throw laborers out of work, and cut down their purchases of materials and supplies, because of a current or prospective lapse of profits. It is to the interests of Russians as producers to keep the wheels of industry turning just so long as it is to the interests of Russians as consumers to have the goods that are thus made available.

The Employment of Labor. Russia also likes to be known as "the land without unemployment." Indeed, the national constitution now promises every person a job. In the past, some Russians have been excluded from employment in socialized industries because of their connection with the old régime, but this policy has been discontinued. Certainly, Russia has had but little unemployment in the

past. However, it must be noted that there is nothing about the Soviet system which inevitably rules out unemployment. But it seems probable that the planning authorities can prevent unemployment if they devote themselves to the task with wisdom and determination.

In capitalistic societies, laborers are put to work by the business enterprisers, who control the land and capital, only if it appears likely that profits can be made in this way. In the U.S.S.R., laborers work for the government—that is, for society as a whole—and it is profitable for society to put people to work just so long as human wants remain unsatisfied. In Russia, the question of profit from the employment of labor does not arise in the usual sense. The cost of putting additional laborers to work consists of turning over to these workers certain productive resources which could otherwise be used by laborers already at work. In other words, the cost of employing more labor is the necessity for those already at work to get along at least temporarily with smaller real incomes. But this reduction in real incomes for those previously employed will be merely temporary, unless the population of the country should become too large in comparison with the land and capital at its disposal. And even in this event, it would be both possible and desirable to keep at work all who are capable of contributing to production.

Workers' Gains. In addition to providing steady work for her people, Russia claimed to have benefited the workers in other important respects. The standard working day was seven hours in ordinary occupations, and six hours in dangerous trades and for all workers sixteen to eighteen years of age. The workers had every sixth day off. No employment of workers under sixteen years of age was permitted, except for training. The workers enjoyed a full social security program (except that unemployment insurance was not needed or included), and received annual vacations of two weeks to a month with full pay. Most Russian workers in the socialized economy were members of labor unions of the industrial type, and enjoyed wages, hours, and working conditions which were arrived at by so-called collective bargaining. Most workers were on a piecework wage basis, with bonuses for quantity and quality, and assurance that piece rates would not be cut as the workers' earnings rose.

While some of these advantageous conditions had to be changed

for the worse under the stress of emergency conditions arising out of measures for war and national defense, there is little doubt that, considering the limitations of their economic system, the Russian workers were well off just before the war began. This did not mean, of course, that their real incomes and scales of living were as high as those of American workers in similar positions. For a small per capita national income, such as Russia's, was certain to result in low real wages and scales of living, no matter how fairly and equitably that income was divided among the citizens, or how favorable the working conditions that were provided.

Criticisms of Russian Economic Planning Prior to 1941

Russian Statistics. We have no thought of suggesting that no problems remained unsolved in the U.S.S.R. as of 1941. Actually, the results of the Russian planned economy could be criticized in many ways. In the first place, there was the question of the reliability of the statistics on production, income, wages, and other matters. Almost the only source of data was the Russian government itself (or various agencies of the government), and this was clearly a biased source. The Russian government, operating a planned economy in the midst of a skeptical world, was doubtless anxious to have its economic affairs appear in a favorable light, and there was a possibility that this government, like other governments, might touch up its statistics at times. Moreover, there was no way to check these statistics adequately, and thus to measure and correct any inaccuracies that might exist.

The Russian government and its agencies sometimes gave statistics in terms of "current rubles" and again in terms of "rubles of 1926–27 value." Data presented by different governmental agencies, covering exactly the same economic activities, often varied widely, and attempts were seldom made by these agencies to account for the discrepancies. However, it may be said for Russian statistics that they show both the successes and failures of planned operation, and that they would still indicate a remarkable degree of economic progress over a limited period of time, even if they had to be discounted by a very sizable fraction.

The Rapidity of Industrialization. Some critics, while conceding that rapid economic progress has been made in the U.S.S.R., were inclined to discount this progress because of the low level of economic activity from which the planned economy started. It is ob-

viously much easier to double a small national income than a large one. An absolute increase which would double the number of industrial workers employed in Russia might cause only a 10 per cent rise in the number employed in this country. It has been suggested that economic progress in Russia under planning proceeded but little, if any, faster than American economic progress in the early days of this country, if allowance is made for differences in the conditions under which the progress occurred. According to this analysis, economic activity in Russia will expand much more slowly in the future than in the past. As evidence on this point, the critics call attention to the fact that the third Five-Year Plan called for an increase in industrial output of only 92 per cent, as compared with 136 per cent for the first Five-Year Plan and 114 per cent for the second.

Opposed to these critics were others who claimed that the process of industrialization had been too rapid, so that waste and inefficiency resulted. They insisted that a more gradual process of industrialization would have produced much better results. The Russian planners have been greatly interested in large-scale enterprises and this interest is said to have interfered to some extent with rapid industrialization. For example, in setting up an electric heat-and-power station in Moscow, the plans called for a giant station with a capacity of 200,000 kilowatts. Construction was started in 1932, but the plant was still unfinished at the end of the second Five-Year Plan in 1937. If the Plan had called for 8 or 10 stations of 20,000 or 25,000 kilowatts each, some of the stations at least could have been in operation by 1937.

Standards of Living. In 1932, at the end of the first Five-Year Plan, the output of consumers' goods in Russia was estimated at 16.2 billion rubles, and that of producers' goods at 19.1 billion rubles; in 1940 Russia's output of the means of production exceeded her output of consumption goods by more than 56 per cent.[19] Again, it was estimated that, under the first three Five-Year Plans, Russia would take close to a third of her national income in the form of capital goods.[20] If we value the ruble at about five to the dollar, the entire Russian national income of 125.5 billion rubles in 1940

[19] *Handbook of the Soviet Union*, pp. 69, 70; and N. Vosnesensky, *Economic Results of the U.S.S.R. in 1940 and the Plan of National Economic Development for 1941*, p. 14.

[20] E. R. Sikes, *Contemporary Economic Systems*, p. 277.

becomes a little over 25 billion dollars for some 170,000,000 people. Russia's extensive program of capital formation, in the face of a national income which is small to start with, called for sacrifices on the part of consumers. We are not surprised, then, to hear that the average standard of living in Russia was far below that of the United States or Great Britain. However, the average Russian was probably better fed, dressed, and housed than ever before, even if he was not particularly well off according to American standards.

It may be contended that Russia had not yet given convincing proof of success in adapting planned production to human desires. With the people in sore need of goods of almost all kinds, it had in the past been easy for the planning authorities to direct production so that the goods produced would be wanted by consumers. When Russian productivity has advanced so far that the basic wants of the people have been cared for, the problem of turning out the kinds and quantities of comforts and luxuries that people desire will be a more difficult matter. The real test of planned production in satisfying the desires of consumers is still to come.

Labor Difficulties. We have seen that the distribution of income in the U.S.S.R. was controlled in such a way that there was but a slight degree of economic inequality. This control of distribution was quite desirable from several points of view, but incomes must not be made so nearly equal as to destroy individual incentive to efficiency. Why should a laborer work hard and develop maximum efficiency if he will get the same, or very nearly the same, wage as the worker who toils just enough to hold down his job? Will people be anxious or even willing to take difficult and responsible managerial positions in industry if they receive in such posts an income which is only moderately higher than that received by ordinary labor? Will those in managerial and executive positions operate their plants with the utmost efficiency if they can get the same, or almost the same, income by operating only efficiently enough to avoid censure or punishment? Will they devise new processes and better methods of production if these achievements cannot result in profit to themselves? Will people of inventive talent exercise their genius if their inventions benefit them only indirectly, through the increased productivity of society? Many people feel that Russia had reduced inequality in the distribution of income to such an extent as to destroy or greatly weaken individual initiative.

On this important point there was as yet no conclusive evidence.

It apparently was true, as was frequently alleged, that the Russian system had been slow to show improvements in the efficiency or productivity of workers. Great increases in physical productivity had occurred, but it is held by some that quality had not been significantly improved, nor had costs of production been greatly reduced from their extremely high original levels. Increased production had apparently resulted from the use of larger and larger quantities of the productive agents, rather than from greater efficiency in the operation of existing facilities. The efficiency of Russian workers, using similar equipment, had been variously estimated at one-half to one-fourth that of American workers, and the waste of materials by Russian workers was said to be excessive.

The planning authorities were aware that Russian labor was often inefficient, and had taken steps to remedy the situation. Bonuses and premiums of cash or scarce commodities, publicity, public honors, and other devices had been used. Some workers had been made heroes of labor, which rank entitled them to extra cash, free street-car service, low taxes and rents, larger pensions, and superior living space, but the problem had not yet been solved. If the difficulties are temporary in character, they may perhaps be attributed to the rapidity of industrialization in Russia and to the fact that millions of people with no previous industrial experience have been trying to learn quickly the operation of modern industrial equipment. But if they should prove to be permanent in character, they may indicate the existence of a serious defect in the Russian scheme of things.

The Question of Individual Freedom. Finally, if economic progress in Russia had continued, and her people had eventually become better off in a material sense than the people of other countries, there would always have been some to say that the Russian citizens had purchased economic welfare at too high a price. In Russia the interests of the individual had been largely subordinated to those of society. Economic activity had been regimented and controlled by the government. The institution of freedom of enterprise, so highly cherished in capitalistic countries, had been done away with in the U.S.S.R. Competition, which is often called the life of trade, was no more. The chance to start out poor and wind up rich did not exist. Under such conditions, say the rugged individualists, life would not be worth living for anyone with ability and initiative, despite the assurance that the government would

provide a fairly good real income. This question of the relative merits of individual freedom and economic welfare is, of course, one which every person must answer for himself.

Soviet Russia in World War II

Early Economic Losses. After the beginning of the war with Germany, the Russians gave ground rather rapidly before the invaders. From June, 1941, to the end of 1942, the part of Russia conquered by Germany was as large as the eastern and southern portions of the United States, including Texas. The area contained half of Russia's working coal mines and 37 per cent of her railroad mileage. It had formerly produced 45 per cent of Russia's wheat, 41 per cent of the rye, 90 per cent of the sugar beets, two-thirds of the iron ore, 60 per cent of the pig iron, half of the steel, 25 per cent of the machines, and half of the electric power.[21] Many people outside of Russia felt sure that these losses would soon prove crippling.

Production Successes. But in spite of the losses just listed, Russia's war production on the whole was not only maintained but increased. The secret of this success was the rapid development of the Ural and Siberian regions. The machines and equipment of whole factories were "leapfrogged" from western Russia to these new regions. In preparation for such a development, machines had been lightly anchored in place and numbered for reassembling. They were loaded on cars, sometimes several thousand cars to a factory, and moved hundreds or thousands of miles. In the new regions far to the east, sites had been cleared in readiness or were rapidly cleared. Some factory buildings had already been constructed and others were soon erected. Sometimes large numbers of workers were moved, along with the machinery and equipment, and were housed in hastily constructed barracks.[22]

The Russians had large stock piles of some essential materials, and were also able to rely on local materials in the new regions to a considerable extent. The Ural region, for example, contains all but four of the known chemical elements.[23] Reliance was also placed

[21] E. Snow, *People on Our Side*, pp. 69, 70; and M. Dobb, *Soviet Planning and Labor in Peace and War*, New York, International Publishers, 1943, pp. 101, 102.

[22] *Ibid.*, pp. 102–107.

[23] E. Snow, *People on Our Side*, p. 147.

on intensification of the workers' efforts, curtailed replacements of machinery in non-essential fields of production, standardization of products, improvisation, and training on the job. Women and young people of both sexes were brought into employment, given rapid training, and stimulated by honors and socialist competition. Housewives were changed into factory workers in two weeks' time. Technical training programs were rapidly extended and eventually included about half of all students beyond the seventh grade.

In agriculture, war losses of acreage were rapidly replaced as some 3¾ million acres were brought into use in Siberia, 2½ million acres of victory gardens were cultivated by 10 million people, another 2½ million acres were cultivated through factory auxiliary-farms, and some 20 million acres were brought into use by collective and state farms which had not been overrun by the invaders. Working days per individual on the collective farms were stepped up sharply. By 1943, some 70 per cent of all agricultural workers were women, and a million more women were in training to handle heavy machinery.[24]

In comparison with what most people expected, Russian war production was truly prodigious. Indeed, Russia conducted the war against Germany almost entirely on her own power in 1941 and 1942. From the beginning of the war through the siege of Stalingrad, Russia received only about a billion dollars' worth of aid from the United States and Great Britain, and such an amount of munitions and supplies did not go far in World War II. On the other hand, Russia required large amounts of material assistance from her Allies in order to drive the enemy out of the country and back to the heart of Germany.

The Problem of Rehabilitation. Under the circumstances prevailing at the time, it was not surprising that Russia failed to adopt a new Five-Year Plan in 1943, but instead embarked on a course of rehabilitating the devastated areas of the country as fast as they were reconquered. Some 1710 towns and cities, 70,000 villages, and 6 million buildings had been partly or completely destroyed, and 25 million people had been made homeless. About 32,000 industrial plants and 98,000 collective farms had been ruined. The total damage was estimated at 679 billion rubles at 1941 prices.[25] Accordingly

[24] *Ibid*, pp. 103–110.
[25] *International Labor Review*, January–February, 1946, p. 71.

the Russians set out to build or rebuild several million square meters of dwelling space, and thousands of factories, schools, and hospitals. Millions of cattle, sheep, goats, and horses were returned to the west, thousands of tons of seed were made available for reconquered areas, thousands of tractors were brought back from the east, hundreds of machine-tractor stations and tractor repair shops were rebuilt, thousands of agricultural leaders and specialists were brought back, railroad lines were restored, and railroad stations were rebuilt.[26]

The Fourth Five-Year Plan

Details of the Plan. By April, 1946, about a year after the end of the war with Germany, Russia was ready to embark on a fourth Five-Year Plan, even though the work of rehabilitation had only got well under way. The new plan seems as ambitious as any of the others. By 1950, the gross product of industry is to be increased to 205 billion rubles (as compared with 137.5 billions in 1940), new capital investments are to amount to 157½ billion rubles, and new agricultural machinery valued at 4½ billion rubles is to be supplied (as compared with 1.9 billion rubles' worth under the second Five-Year Plan). National income will increase, according to the Plan, to 177 billion rubles in 1950 (as compared with 125.5 billions in 1940); expenditures on education and culture will increase to 160 billion rubles over the period, or 2¼ times the pre-war expenditures; technical schools will be expanded to accommodate 1,200,000 students; some 42 billion rubles will be spent for the construction of 72,000,000 square meters of new housing; small hydroelectric stations with an aggregate capacity of 1,000,000 kilowatts will be constructed for rural electrification; over 3 million acres of land will be reclaimed by irrigation or drainage; and over 40 billion rubles will go into the restoration and development of railroad transportation.[27]

In Table 27 we present the estimates of planned production of a number of important commodities in 1950 in comparison with actual production in 1940. It will be noted that some of the goals of the fourth Five-Year Plan are only slightly higher than those

[26] *Ibid.*, p. 72; and *The U.S.S.R. in Reconstruction*, New York, American-Russian Institute, p. 43.

[27] *Soviet Russia Today*, May, 1946, pp. 32, 33.

TABLE 27. PRODUCTION OF SELECTED COMMODITIES IN SOVIET RUSSIA IN 1940, AND PRODUCTION PLANNED FOR 1950 [a]

Item	Units	Actual Production in 1940	Production Planned for 1950
Petroleum	Million tons	34.2	35.4
Coal	Million tons	164.7	250 0
Electric power	Billion kilowatt-hours	48.2	82.0
Pig iron	Million tons	14.9	19 5
Steel	Million tons	21.8	25.4
Copper	Thousand tons	157.0	251.2
Automobiles	Thousands	194.9	500.0
Locomotives	Thousands	1.6	3 8
Grains	Million metric quintals	1190.0	1273.3
Raw cotton	Million metric quintals	25.2	31.5
Flax	Million metric quintals	6.7	9.3
Sugar beets	Million metric quintals	222.0	270.8
Cattle (on collective farms)	Million head on hand	20.1	25.9
Sheep and goats (on collective farms)	Million head on hand	42.0	68.1
Pigs (on collective farms)	Million head on hand	8.2	11.1

[a] Source. *Soviet Russia Today,* May, 1946, p. 33

actually reached in 1940, but in most cases very large increases in production are expected. Whether or not these increases can actually be achieved remains to be seen. In the meantime, the Russians are at least entitled to an "E for effort."

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1. What is the importance, to students of economics, of examining the operation of the Russian planned economy?
2. Explain the organization of the Communist party, and its importance in Russian political and economic affairs.
3. Outline the governmental organization of the U.S.S.R.
4. Is the government of the U.S.S.R. really as democratic as its constitution suggests? Explain.
5. How are economic activities planned in Russia?
6. Why is it often said that Russia has a "two-way" system of economic planning?
7. Distinguish between the functions of plants, trusts, and administrations in Russian industry.

8. Is the relationship of prices to costs of production a significant one in the Soviet economy? Explain.
9. Are there reasons for expecting that planned production can be adapted to the wants of consumers in Russia? Explain.
10. How does the status of agriculture differ from that of industry in the U.S.S.R.? Explain.
11. How do state farms, collective farms, and individual peasant farms differ in organization, operation, and importance?
12. What are the factors which determine the amount of income which a worker on a collective farm will receive in a given year? Explain.
13. As a Russian farm worker, would you prefer to be on a state farm or collective farm? Why?
14. How are existing supplies of land and capital apportioned among the various industries in Russia?
15. How is the total volume of saving and investment, in terms of physical units, controlled in the U.S.S.R.?
16. How are financial results made to match the physical results in connection with the process of saving and capital formation?
17. Why is it true that the cost of obtaining capital goods is the same in Russia as in any other type of economic system?
18. On what basis is the Russian labor supply distributed among occupations and industries?
19. Why are differences in wages permitted among workers in Russia?
20. How great are these wage differences? Explain.
21. Explain the various ways in which consumers' goods have been distributed among consumers in Russia.
22. What progress has the Russian economy made toward its goal of having a single set of merchandising units selling to all purchasers at a single scale of prices?
23. How is international trade handled by Soviet Russia?
24. How does the monetary problem in Russia differ from that faced by the governments of other countries? Explain.
25. Give a general estimate of the results of planned operation in the Russian economy.
26. "The rapid industrialization of the U.S.S.R. may be considered as either an advantage or a disadvantage." Explain.
27. Is Russia "the land without depressions"? Why?
28. Why is it difficult to evaluate the economic accomplishments and failures of the U.S.S.R.?
29. Had Russian consumers benefited greatly under the planned economy up to 1941? Explain.
30. What labor difficulties has Russia encountered? Explain.
31. "The evaluation of the Russian economy depends in part on the issue of individual freedom versus economic welfare." Explain.
32. Indicate the economic losses which Russia suffered early in her recent war with Germany.
33. How was Russia able to maintain and even expand war production in spite of the loss of important territory? Explain.

34. Why was no new Five-Year Plan undertaken by Russia between 1942 and 1946?
35. "The fourth Five-Year Plan seems to be as ambitious as any of the others." Explain.

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26. *Fascism*

Socialism is not the only alternative to capitalism that has been available in recent years, for a number of countries have been operating under another type of system known as fascism. While the most important fascist systems—those of Germany and Italy—were liquidated by their defeat in World War II, it is still too early to conclude that fascism is dead and buried and can safely be relegated to the history books. Hence we shall examine briefly the nature of fascist governmental and economic systems.

Fascist Government

The Dictatorship. Using the German and Italian systems as examples of fascism, we may note that the fascists came into power by securing control over the existing forms and agencies of government, rather than by revolution or the violent overthrow of existing governments. Once in power, the fascists went on to eliminate some governmental institutions completely, to purge or "purify" others to suit their purposes, and to permit still others to go on functioning virtually without change. The result was a very strong central government which exercised rigid control over the activities of lesser governmental units and of private individuals. And the powers of the central government were concentrated to an almost unbelievable extent in the hands of one man, the great leader and dictator, and his trusted associates.

In the governments of fascist countries, the executive department of the government was supreme. The dictator himself held the highest executive office in the government, and other key positions as well, and his loyal henchmen held most of the other important positions. As many governmental posts as possible were filled by appointment rather than election, to guard against the possibility that undesirable characters might get into office. Legislatures were retained, but seemed to serve no very useful purpose.

They met rarely, did very little legislating since the dictators had the power to make laws by decree, and functioned primarily as sounding boards and cheering sections for party propaganda and declarations of the dictators as to accomplishments and policies. The existing court systems were retained in general, but non-fascist judges were replaced by loyal fascists. The courts had no power to restrain the executive department of the government, their functioning being limited to dispensing the fascist version of "justice." The fascists took a very serious view of political crimes, or offenses against the state, the fascist party, or the dictator; set up special courts to give short shrift to persons accused of such offenses; and maintained a powerful and dreaded secret police force, operating at least partly outside the laws and forms of government, to ferret out such persons, round them up, and bring them to justice.

The Fascist Party. The fascist countries, like Soviet Russia, had one-party systems of government. In each country, no political parties or organizations were tolerated except the fascist party, by whatever name it might be called. The fascist party in each case had only a few million members and included only a very small part of the citizens of the country. Except by special permission from above and in highly exceptional cases, the party did not accept new adult members. Instead, it relied upon the development of new members from junior fascist organizations. Both boys and girls were members of youth organizations, which included groups of all ages from 5 to 6 up to 21. Several million budding fascists were to be found in the various youth organizations of each important fascist country.

The requirements for party membership were rather severe, and included blind devotion, loyalty, and obedience to the leader or dictator, and a willingness to devote one's time, labor, and money or other resources to the objectives of the leader and the party. The members of the party were reexamined periodically to see if they were exhibiting the prescribed fascist virtues. If found wanting, they were at least expelled from the party, and were sometimes jailed or even liquidated. Nevertheless, party membership was eagerly sought in the heyday of fascism, for it carried with it both prestige and a variety of economic advantages.

The identification of fascist party and government was virtually complete. The dictator or head of the government was also the leader of the party. His trusted associates were high officials of

both party and government. The party had a cabinet which paralleled the cabinet of the government and contained many of the same people. All along the line, governmental officials and agencies were matched by party officials and agencies with considerable overlapping of personnel. As head of the government, the dictator had general charge of appointments to governmental positions, and as head of the party he had similar charge of appointments to positions in the party. Thus, for all practical purposes, the fascist party was the government.

Individual Liberties. In each country, the fascist party regarded democracy as useless and an evidence of weakness on the part of a nation, and found it desirable to suppress practically all rights and liberties of individuals. Freedom of assembly did not exist outside the all-powerful party. Freedom of speech was a meaningless term, for any criticism of, or outspoken opposition to, acts and policies of the government or fascist party was likely to be interpreted as treason. The press was also controlled entirely by the government and printed only government-approved "news." Education was strictly controlled by the government, in order that the principles of fascism might be inculcated in the youth of the land. In Germany, even religion became largely a function of the ruling party. Religious leaders were displaced by other persons who would be amenable to the wishes of the party and would extoll the virtues of fascism, and it was reported that the Bible had been rewritten to conform to party principles. In Italy, however, the Catholic Church continued to function on the basis of an agreement with the ruling party, although relationships between the church and the government were not particularly cordial.

Under fascism, a man's house was not his castle if we may believe the critics of fascism. A citizen's house was likely to be invaded and his personal possessions destroyed at any time by governmental representatives acting without warrant. He could be arrested without warrant, tried without jury or legal representation, and given an exceedingly severe sentence. The law was whatever the leaders said it was. It could be one thing one day, and quite another the next. A man could be punished, under retroactive laws, for an act which was not a crime or a misdemeanor at the time at which it took place. He could be punished for crimes which it was presumed he would commit in the future, and for offenses which others might conceivably commit against him—this last type of

punishment being called "protective arrest." He could be confined without specific charges being lodged against him. He could be arrested and punished merely for stating that a crime had been committed—the name of this offense being "the spreading of atrocity legends." Moreover, the people of the fascist countries were subjected to espionage on the part of the government to an extent which has seldom been equaled.

About the only right which was left to the individual citizens was the right to vote, and this did not amount to much since comparatively few governmental offices were filled by election. However, the ruling party would stage an occasional election of the figurehead legislature or a referendum on the policies which the government had been following over a period of time. On these occasions, great pains were taken to see that the people came out to vote, and that they voted as the leaders desired. The results of the elections or referendums were a foregone conclusion.

The Suppression of Opposition. Opposition to fascism was regarded as a kind of social disease which had to be eradicated as quickly as possible, and the favorite method of eradication was violence. Sluggings, beatings, and other forms of mob violence were common. Large numbers of people were murdered outright. Far larger numbers were thrown into prison, or into concentration camps similar to the camps maintained for prisoners in time of war. Many people simply vanished completely, leaving no trace. Others allegedly committed suicide because they feared arrest and punishment. In jails and concentration camps, the mortality due to pneumonia and other "natural causes" was extraordinarily high, and many prisoners were reported to have been "shot while trying to escape."

In Germany more than in Italy, the program of suppression had a strong racial tinge. Opposition had to be suppressed for the good of the state, but that was considered synonymous with the good of the race. According to the party program, none but members of the nation could be citizens of the state, and none but those of German (or Aryan) blood could be members of the nation. No Jew, therefore, could be a member of the nation, and much of the fascist program of persecution and terrorism was directed against the Jews. The Germans were said to be psychologically powerless to admit that the loss of World War I and the unfortunate economic conditions which followed were due to any faults of their own. They held

that the war was lost because of the treachery and duplicity of the Jews at home, and that the Jews were responsible, also, for the unfavorable economic conditions of the post-war years. Moreover, economic recovery and prosperity were said to wait upon the elimination of the Jews from the population.

According to Jewish refugees from Germany, it is impossible to describe briefly the treatment to which the Jews were subjected under fascism. They were deprived of citizenship and the right to vote. They were cast out of the professions, such as teaching, medicine, journalism, and the law. They could not belong to labor unions, or work in retail and mercantile fields. Their property was confiscated in many cases, and they themselves were subjected to close espionage. The rights of their children to education were curtailed, as was also their right to make a livelihood through the use of land. They suffered personal indignities and physical violence, and severe injury or death was the portion of many. Some of the more fortunate were able to flee the country, but those who remained lived in a constant state of terror and abject misery, if indeed they lived at all.

In Italy the campaign of suppression was directed chiefly against living persons, and especially against those in Italy at the time; but in Germany the works of famous German writers of the past and of citizens of other countries were condemned by the fascists. Such works were banned from circulation, and were burned in monster bonfires staged for this purpose. Objectionable paintings were removed from art galleries, and other works of art destroyed. Even the performance of musical compositions by certain composers was forbidden. The fascists declared that the German nation and race should work out its own art and culture, so that they might be free from alien contamination.

Italy, in the early days of fascism, was not conscious of a "Jewish problem" that needed attention. Later on, however, the assumed necessity for a common front between the fascist nations led the fascist government of Italy to introduce a program of anti-Semitism, even though the Jews in Italy numbered only about 50,000 out of a total population of 43,000,000. It was said that the Italian government experienced great difficulty in arousing enthusiasm for this program since many Italian people had never even seen a Jew.

The Individual and the State. The fascist philosophy required a strong central government to which the individual citizens were

subjected and subordinated. Ordinary individuals were considered too ignorant or too thoroughly immersed in the private affairs of life to carry on the affairs of government successfully. This task had to be undertaken by the chosen few, who were found in the fascist party. The subordination of the individual to the state was not for his own good, as in Russia, but for the good of the state. The state was thought of as something more than an aggregate of the individuals who made it up at any particular time. For fascism, society seemed to have historical and immanent ends of preservation, expansion, and improvement quite distinct from those of the individuals who at a given time composed it; so distinct in fact that they might even be in opposition.[1] Individuals were regarded as merely the means by which society might reach its goals, and as but temporary and relatively unimportant elements in the long life of the state.

Moreover, according to the fascist philosophy, the individual cannot exist without the state. Apart from the state, the individual has no more purpose or reason for being than has one body cell isolated from the human body. For the individual to assert his rights against the state would be as ridiculous as for a body cell to rebel against the body as a whole. Thus, the individual has no rights which are superior to those of the state. He has merely a duty toward the state and, in performing this duty, he may be expected to sacrifice everything, even life itself. The interests of the state permeate all activities of the individual, and not merely his political activities. This general theory helps to explain why the rights of individuals, as we are accustomed to view them, were largely suppressed in the fascist countries. The fascist theory of the state was seen in action in the economic policies of fascism, most of which were intended to promote the greater glory of the nation, rather than the welfare of the individual citizens.

Fascist Economic Organization and Policy

Economic Institutions of Fascism. The operation of fascist economic systems involved no change in the nominal character of the economic institutions of the countries. The fascist leaders, in other words, professed great admiration and respect for private property, free enterprise, individual initiative, and competition, and proposed

[1] Julia E. Johnsen, compiler, *Capitalism and Its Alternatives*, New York, H. W. Wilson Company, 1933, p. 376.

to rely on these capitalistic institutions for the operation of the economic system so far as this course of action produced desirable results. However, the goals of the state or nation were to be supreme; and, if the operation of capitalistic institutions tended to produce results which were inconsistent with state objectives, the government would have to step in with appropriate interferences and controls.

The fascist leaders declared repeatedly that they did not intend to set up an economic system like that of Soviet Russia, in which the state owns and operates the basic means of production, and individual initiative is weakened if not destroyed. Indeed, the system was not intended to be permanently even a governmentally controlled system. The government did not propose to direct industry and trade in the long run, but intended merely to open up the way for private industry and trade. In practice, however, as the fascist countries moved into preparation for war and finally war itself, the government found it necessary to direct and control the economic system more and more completely, and its interferences in all types of economic activity multiplied rapidly. In the latter days of fascism, the economic system came to be controlled by the government as completely as that of Soviet Russia, though by different methods. The fascist economies also came to be planned economies, though the planning which took place was more opportunistic and less formal than that of Russia.

The Control of Industry. Strict governmental control over industrial production was, of course, a basic feature of the fascist economies. Long before these systems met their end, enterprisers in industry were being told what they could and could not produce; how much to produce of various goods; how many hours a week they could or should operate; whether they could replace machinery and equipment and, if so, at what prices; whether they could have any raw materials and, if so, how much and at what cost; whether they could import or export anything and, if so, in what quantities and at what prices; how many workers they could have, how many hours per day the workers could be employed, and what they should be paid; what prices could be charged for finished products, and a number of other things. Underneath this thick layer of governmental controls, industrial enterprises were still privately owned and operated, and were supposed to operate for profit as usual.

The control of production was accomplished through a complex network of governmental agencies constructed for the purpose. These agencies were so numerous and complicated that it does not seem worth while to study them in detail in a book of this kind, now that they have ceased to function. The control agencies normally included representatives of business enterprisers and the government, and sometimes admitted workers' representatives as well. In drawing up the regulations which would govern production, attention was usually paid to the wishes of business men as well as those of the government. Once the regulations had received the approval of high governmental and party officials, they operated with the force of law on all enterprises subject to them. Since productive enterprises were still privately owned and operated, they still required the stimulus of "profits," and the regulation of production was usually so contrived that business men could make plenty of money, though governmental control over production was complete.

The Control of Agriculture. Fascist production controls extended to agriculture as well as industry. Production, price, and marketing controls were exercised through agencies similar to those for industrial control. Programs of land reclamation and resettlement were undertaken, the movement of labor into and out of agriculture was controlled, subsidies in cash or kind were paid to the growers of various crops, and the prices of some products were raised in an effort to stimulate production under the self-sufficiency program. In Germany an effort was made to provide a new status for deserving farmers; that is, if the farms and their owners qualified for the honor, the farms could be made hereditary and inalienable, and not subject to sale, mortgage, or division, and the owners acquired the right to call themselves "peasants."

The fascist farm policies undoubtedly contributed something to the state or national objectives of economic independence and preparedness for war, but they were of little benefit to the ordinary farmer. No really determined attack was made on many fundamental farm problems, such as tremendous concentration in the ownership of farm land, farm tenancy, and the great disparities in income and economic welfare which existed between poor and prosperous farmers. Even the increased prices of farm products brought no benefit to the ordinary farmers, who usually consumed all they were able to produce and even had to buy more in many cases. The gov-

ernment's subsidies, free labor, and other benefits for farmers also went primarily to the large farmers.

The Control of Marketing. In wholesaling, retailing, and other branches of marketing, the fascist government used control agencies and regulations similar to those employed in other fields, and the individual enterpriser was tied hand and foot in this field as elsewhere. The policies of economic self-sufficiency and preparation for war resulted in severe shortages of ordinary consumers' goods and a thoroughgoing system of rationing became necessary. This rationing program may have served to distribute fairly equitably among the citizens the burdens and hardships resulting from other fascist economic policies, but the rations made available to the people inevitably resulted in restricted consumption and lowered scales of living.

General systems of price control were also put into operation in the fascist countries, and were undoubtedly necessary and desirable in view of the other economic policies which were being followed. However, since the price controls were imposed not on governmental enterprises but on private enterprises operated for profit, they operated none too efficiently and many devices for evading them were invented and adopted by business men. Among these were simple black-market dealings, combination sales, the upgrading of commodities, reductions in quality, reductions of quantities in packages, the multiplication of new products and brands, and concentration on the higher-priced varieties of goods. Thus, effective stabilization of prices occurred only in the official statistics or price indexes of the fascist governments, despite the severe penalties which were provided for violations of the price decrees.

The Control of Banking and Credit. Familiar control agencies and regulations appeared in the fields of commercial and investment credit and banking in the fascist countries. In commercial banking, individual banks were licensed and controls were imposed on interest rates, the sizes of loans which could be made to various firms and enterprises, and the size of bank reserves and the forms in which they should be held. Each banker was practically a state official as well as a private enterpriser, and was likely to have a party man to watch over and "protect" him at all times. When instructed by the government, and without regard for his own opinions and desires, he had to advise his customers to purchase government bonds or the securities of new concerns which were being

set up to produce ersatz or substitute products under the national self-sufficiency program. He had to hold the official, optimistic view of state finances. He had to try to restrain individuals who wanted to withdraw their deposits for private uses, report those who did make large-scale withdrawals, and inform the government about individual customers who had large liquid balances.

In the field of investment credit and banking, there were also many controls. Interest rates on other securities were beaten down by the government in order to create a more favorable market for government bonds. The dividends which corporations were allowed to pay on their stocks were strictly limited. The earnings which the concerns were thus compelled to retain might be invested in the same lines of production if the corporations were producing articles which were of importance under the self-sufficiency or armaments programs. Otherwise, the government would "persuade" the corporations to invest their earnings in new companies which would contribute to such programs, or in government bonds which would place the funds directly at the disposal of the government for the same purposes. New security issues on the part of private industrial and business concerns were severely curtailed, and private firms were made to look to the government for investment funds. Firms producing ordinary consumers' goods were not allowed to sell new securities, could not obtain additional investment funds from the government, and under price control were often unable to acquire adequate earnings of their own for purposes of reinvestment. Thus the entire investment-credit mechanism was brought under the thumb of the government and investment funds were diverted into fields of production which were deemed consistent with the attainment of national objectives.

The Control of International Trade. The governments of the fascist countries used every device in the books in their efforts to control the foreign trade of their countries. The methods employed included protective tariffs, import and export licenses and quotas, foreign exchange controls, export subsidies, private trading agreements, clearing agreements, payments agreements, direct intergovernmental barter deals, and other devices. However, the fascist countries did not maintain a very large volume of international trade on the basis of these controls, and soon turned to comprehensive programs for achieving national economic self-sufficiency. As we noted in Chapter 15, these self-sufficiency programs

included increasing the production of articles which were already being made in the fascist countries in amounts inadequate for domestic needs, attempting to substitute articles which were relatively less scarce for others which were relatively more scarce, and producing artificial substitutes for articles which could not be produced in the fascist countries by natural methods. There are obviously no direct gains in terms of maximizing production and scales of living to be obtained from the curtailment of international trade and the development of national economic self-sufficiency. The most that can be said of these policies, as of other fascist control policies, is that they were apparently consistent with the national goals of independence and readiness for aggressive warfare.

The Control of Labor and Industrial Relations. Labor and the relations of workers and employers, like virtually everything else, came in for very rigorous control by the governments of the fascist countries. The fascist leaders wanted to maintain industrial peace in the interests of full production and they succeeded in doing so, but only at great cost to the workers, if not to the employers. All labor unions were smashed and liquidated, along with their headquarters, meeting halls, and publishing plants. Their newspapers were suppressed, and their funds taken over by the government. The workers were forced into government-inspired and -controlled organizations, headed by party men and interested primarily in seeing that the interests of the nation (as the fascist leaders saw them) did not suffer as a result of anything that went on in the field of industrial relations. The workers had no real right to bargain collectively with their employers. They were allowed to use none of the weapons of industrial conflict, such as strikes and picketing, to bring their desires forcefully to the attention of their employers. And the wages, hours, and working conditions which are so important to workers were determined, except for the supervision and intervention of the government and its agencies, by the fiat of the employers and at their pleasure.

The employers were also deprived of their usual private organizations, they were called upon to give up their tried and true weapons and practices of industrial conflict, and they were subjected to many burdens by the government and the fascist party. However, except for governmental intervention, the employers still held the upper hand in their direct dealings with the workers because of their natural superiority of bargaining power. The equal treatment of

parties unequal in strength still leaves them unequal in strength. The fascist governments made an effort to protect the workers from the rapaciousness of the employers through confidential councils, labor trustees, labor courts, and courts of social honor, but there is reason to suspect that these elaborate devices were far from completely successful.

The situation of the workers of the fascist countries with respect to wages, hours of work, and working conditions in general was not favorable even before World War II, and in the war period it became steadily worse. The famous (or infamous) work-books or labor passports, wages frozen at unsatisfactory levels, the conscription or drafting of workers of almost all kinds, the freezing of workers in their jobs, the application of military or semimilitary regulations to the workers, severe penalties for breaches of labor discipline, and the suspension of former legal restrictions on hours of work and other working conditions were all part of the order of the day in the fascist countries.

The workers were supposed to be compensated for these unfavorable conditions in a number of ways. First, they had the benefits of the Dopolavoro (After Work) and Strength Through Joy movements, through which the workers participated in low-cost vacation trips, sports, concerts, plays, operas, vaudeville and moving-picture performances, lectures, art exhibits, tours of museums and art galleries, and other recreational and educational events. However, they had almost no freedom of choice or conduct in their leisure-time activities and were the "beneficiaries" of a strong program of political education in these activities—which meant that plays, movies, concerts, operas, lectures, and other activities were all coordinated with the fascist philosophy. In the long run the workers themselves did much of the paying for the activities of Dopolavoro and Strength Through Joy, and these activities were regarded by the fascist leaders in part as a means of keeping the workers out of mischief in their spare time. The activities were also intended to keep the workers reasonably happy and contented, so that they would be easier to govern and more productive.

Second, the workers were supposedly compensated by the relative certainty of finding employment as the fascist systems moved through preparedness to war, but the satisfaction provided by full employment was lessened by the prevalence of working conditions that approached slavery, and by lowered real incomes and scales of

living. Third, the workers gained something under the systems of social security which the fascist governments maintained, although many people were not covered by some of the types of social insurance, the benefits received by the insured were often pitifully inadequate, and the cost of the insurance was borne to a great extent by the workers themselves. Finally, there was the joy the workers were expected to experience in realizing that they were a vital part of a national community which the fascist leaders contended was constantly growing in power and prestige. According to these leaders, the main issue with the workers was not their ridiculous wage-pennies or food and clothing, but rather the dignity and honor of their position. Such contentions require no comment here.

The Distribution of Income. In the fascist countries, the distribution of income remained distinctly of the capitalistic type. With productive wealth privately owned and most industries privately operated, individuals were allowed to receive rent, interest, and profits as well as wages and salaries. There was no tendency for the proportion of the national income going into wages, salaries, and other earned compensation to increase in relation to that going into profits, undistributed profits, interest and dividends, and rent. In fact, the tendency was in the opposite direction, and inequality in the distribution of income among persons increased. There was clearly no feature of the distribution of income in the fascist countries which could be regarded as a desirable accomplishment of fascism unless it was that great inequality in its distribution among individuals was not allowed to accomplish all of its usual evil results, since large portions of the incomes of all classes were taken by the government for its own purposes.

Evaluation of Fascism. The virtually complete governmental control over economic activity which developed in the fascist countries may have resulted in the elimination of some of the competitive wastes of capitalism, but any such gain was offset by an increase in bureaucracy and red tape; by countless regulations, forms, reports, and questionnaires; and by bribery, "wangling," and the necessity of worming into the good graces of fascist officials. The tendency toward industrial concentration and combination which the fascist governments sponsored may have improved the economic position of the surviving enterprises, besides simplifying the problems of governmental regulation and control. However, any joy which the large business men in fascist countries may have expe-

rienced at being relieved of their smaller competitors must have faded rapidly as the party leaders themselves went into business and used the powers of the one-party state for their own economic gain. The economic successes achieved by these party men were extraordinary, and the increases in their wealth and income were often compared with the loot and booty of the robber barons. On the whole, however, there is little reason to think that the technical efficiency of production was lowered significantly under fascism.

Indeed, it may be said that the fascist system of economic control did not compare unfavorably with other systems of complete governmental control from the point of view of the technical efficiency of production and management. In other words, it appears that the fascist system of leaving the risks and responsibilities of operating economic enterprises to private individuals and stimulating these persons by means of competition and the prospect of private profit, while making sure, through governmental controls, that the total economic results produced were appropriate to national goals, may have produced better results on the whole than the Russian system of outright governmental ownership and operation.

However, the results of fascism in terms of efficiency were far from adequate to justify the existence of such a system. Instead of merely maintaining efficiency, a fascist system would have to show tremendously superior efficiency, and a disposition to allocate the results of such efficiency to increasing the economic welfare of the people, before it could make up for the almost complete loss of political and economic freedom which its operation entails. Actually, with no remarkable gains in production, and with an ever-increasing portion of the national income being devoted to the ends of the state rather than to consumption by the citizens, the loss of political and economic freedom led only to lowered real incomes, reduced scales of living, and hardship and suffering.

Such great sacrifices on the part of the people might conceivably have been justified if the ends sought by the fascist states had been noble and humane. Actually, however, the general goal which the fascist countries were seeking—that of attaining national power and glory by means of economic independence and aggressive warfare—was both monstrous and inhumane. It is doubtful that the most persuasive of leaders could have kept the people of the fascist countries devoted to and enthusiastic about such an objective, if the

government had been democratic and responsible to the people. In practice, of course, the objective in question was forced on the people by a strong dictatorial government which controlled almost every phase of their daily lives. And, in the end, the efforts of the fascist governments to reach their objective resulted in dismal failure. Fascism in Italy was unable to produce an economy and a nation which was strong even in time of war. In Germany, on the other hand, an effective war economy was unquestionably developed, but it proved entirely inadequate for the task of world conquest without which the gains that immediately resulted from military conquest could not be retained.

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1. How were the governments of the fascist countries changed in the process of creating dictatorships? Explain.
2. Explain the principal characteristics of the ruling political party in the fascist countries.
3. What happened to the rights and liberties of the individual citizens under the fascist government?
4. How was opposition to fascism suppressed?
5. "In the fascist countries, the program for the suppression of opposition had a strong racial tinge." Explain.
6. What was the fascist theory with regard to the relations of individuals and the state? Explain.
7. Discuss the nature and significance of the economic institutions of fascism.
8. How and to what extent did the governments of the fascist countries control industry?
9. Explain fascist policies and accomplishments in the field of agriculture.
10. Why is it often said that fascist attempts to control prices were not conspicuously successful?
11. Outline fascist policies in the field of commercial and investment credit and banking.
12. "The fascists used practically every known device in controlling the international trade of their countries." Explain.
13. Why is it often said that the fascist countries reduced the status of labor virtually to the level of slavery? Explain.
14. How were the workers supposed to be compensated for their lowly status under fascism? Explain.
15. What happened to the distribution of income under fascism?
16. Present a general evaluation of fascism.
17. Were the governments of the fascist countries successful in attaining their objectives? Give details.

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